Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1971

NO. 71-1191

SHELL OIL COMPANY, *Petitioner*

v.

CARL F. MATZEN, ET AL., *Respondents*

PETITION OF SHELL OIL COMPANY FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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March 14, 1972

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IN THE

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October Term, 1971

NO._____

SHELL OIL COMPANY, *Petitioner*

v.

CARL F. MATZEN, ET AL., *Respondents*

PETITION OF SHELL OIL COMPANY FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Shell Oil Company petitions the Court for a writ of certiorari to review the judgment of the United States Court of Appeals For The District of Columbia Circuit in *Mobil Oil Corporation v. Federal Power Commission*, No. 23,463 entered December 17, 1971, and in support thereof would show as follows:

I. The Opinions Below

The cases below, in which Petitioner, Shell Oil Company, was a party,[1] were decided together with four other cases[2] by the United States Court of Appeals for the District of Columbia Circuit. That Court's opinion is attached as Appendix A (*infra*, pp. 1a-26a). The Federal Power Commission Opinion and Order Determining Jurisdiction, Opinion No. 562, is attached as Appendix B (*infra*, pp. 27a-62a). The Presiding Examiner's Initial Decision on Jurisdiction Over Royalty Owners (FPC Docket Nos. RI67-113, *et al.*) is attached as Appendix C (*infra*, pp. 63a-87a). None of these opinions is yet reported. Appendix D (*infra*, pp. 88a-120a) contains the opinion of the United States Court of Appeals for the Fifth Circuit issued September 20, 1966, reported in 367 F.2d 104, in which the principal questions were referred, under the doctrine of primary jurisdiction, to the Federal Power Commission.

II. Jurisdictional Statement

The judgment sought to be reviewed herein was dated and entered on December 17, 1971. One of the parties to the consolidated appeal before the United States Court of Appeals for the District of Columbia Circuit, J. M. Huber Corporation, filed a Petition for Rehearing on

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1. *J. M. Huber Corporation v. Federal Power Commission*, No. 23,491 (CADC); *Carl F. Matzen, et al. v. Federal Power Commission*, No. 24,051 (CADC); *William Harvey Denman, et al. v. Federal Power Commission*, No. 24,180 (CADC).

2. *Mobil Oil Corporation v. Federal Power Commission*, No. 23,463 (CADC); *Western Natural Gas Company v. Federal Power Commission*, No. 23,511 (CADC); *Amoco Production Company v. Federal Power Commission*, No. 23,633 (CADC); *The Land And Royalty Owners of Louisiana v. Federal Power Commission*, No. 23,654 (CADC).

December 30, 1971, on a limited issue. The Federal Power Commission, on direction from the Court of Appeals, filed a response to that petition. The Court of Appeals has not yet ruled on the Petition for Rehearing. The *Huber* Petition did not ask for rehearing on any of the principal issues decided in the Court of Appeals Opinion which affect Shell Oil Company. It did not bear on any of the questions presented hereinafter set out. No other Petition for Rehearing was filed.

Jurisdiction of the Supreme Court to review this case by writ of certiorari is conferred by the Act of June 25, 1948, c. 646; 62 Stat. 869, 928; 28 U.S.C. 1254.

III. Questions Presented

1. Does the Federal Power Commission have jurisdiction over the payment of royalties for gas sold for resale and transported in interstate commerce where such royalties are claimed at rates higher than allowed producer-lessees?

2. Should the United States Court of Appeals for the District of Columbia Circuit reverse without remanding a jurisdictional finding by the Federal Power Commission on the grounds of insufficient record, where that finding was made in response to a request by the United States Court of Appeals for the Fifth Circuit under the doctrine of primary jurisdiction, or should the D. C. Circuit have remanded the case to the Commission for development of the record on the necessary facts?

IV. The Statute Involved

This case involves the Natural Gas Act, and particularly Section 1 thereof:

"Section 1. (a) As disclosed in reports of the Federal Trade Commission made pursuant to Senate Resolution 83 (Seventieth Congress, first session) and other reports made pursuant to the authority of Congress, it is hereby declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest. [52 Stat. 821 (1938); 15 U.S.C. § 717 (a).]

(b) The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas. [52 Stat. 821 (1938); 15 U.S.C. § 717 (b)]

(c) The provisions of this Act shall not apply to any person engaged in or legally authorized to engage in the transportation in interstate commerce or the sale in interstate commerce for resale, of natural gas received by such person from another person within or at the boundary of a State if all the natural gas so received is ultimately consumed within such State, or to any facilities used by such person for such transportation or sale, provided that the rates and service of such person and facilities be subject to regulation by a State commission. The matters exempted from the provisions of this Act by this subsection are hereby declared to be matters primarily of local concern and subject to regulation by the several States. A certification from such State com-

mission to the Federal Power Commission that such State commission has regulatory jurisdiction over rates and service of such person and facilities and is exercising such jurisdiction shall constitute conclusive evidence of such regulatory power or jurisdiction. [68 Stat. 36 (1954); 15 U.S.C. § 717(c)]"

V. Statement of the Case

By decision issued September 20, 1966, the United States Court of Appeals for the Fifth Circuit, in *J. M. Huber Corporation v. William Harvey Denman, et al.*, 367 F.2d 104,[3] invoked the doctrine of primary jurisdiction and referred to the Federal Power Commission for initial resolution the issues of Commission jurisdiction over royalty interests and the appropriate implementation and exercise of such jurisdiction. In its Opinion No. 562 (42 FPC 164-186),[4] the Commission concluded that it had jurisdiction over royalty interests in natural gas sold for resale in interstate commerce and that such jurisdiction could be implemented without undue additional administrative burden upon the parties or the Commission.

Opinion No. 562 finds that royalty payments represent an interest in the sale of gas and are thereby subject to Commission jurisdiction. The Opinion also finds a valid jurisdictional basis in the "burden" created by royalty claims at rates in excess of producer prices which would interfere with the effective regulation of producer rates. However, since the Commission found that an actual sale for resale was involved, the "burden" theory constituted "an additional, but not the basic, reason for asserting jurisdiction." (Appendix B, *infra*, pp. 36a, 37a)

3. Appendix D.

4. Appendix B.

Judicial review of Commission Opinion No. 562 was sought under the authority of Section 19(b) of the Natural Gas Act (15 U.S.C. § 717r; 52 Stat. 831). The decision of the reviewing court, the United States Court of Appeals for the District of Columbia Circuit, in reversing Commission Opinion No. 562, found that, as a matter of law, the royalty owner's retention of an economic interest did not involve him in a "sale in interstate commerce for resale" within the meaning of the Natural Gas Act. As to the second, or "additional", ground for jurisdiction set out in Commission Opinion No. 562, the Court of Appeals did not find that it was invalid as a matter of law, only that the record was not fully developed on the extent or significance of market price contracts and whether claims based thereon would tend to undercut the Federal regulatory system.

It is petitioner's position that the record contains substantial evidence in support of the Commission's finding that jurisdiction may rest on the necessity to regulate claims for royalty at rates higher than the producer's filed rate, in order to achieve the regulatory purposes of the Natural Gas Act. If, however, there were inadequacies in that record, sound judicial administration would require the case to be remanded to the Commission to develop the evidence needed by the Court to make its decision.

VI. Argument

A. The Federal Power Commission Acted On Substantial Evidentiary Support In Finding That Jurisdiction Could Rest On The Need To Prevent Interference With Effective Producer Regulation.

That Congress intended the Natural Gas Act to create a comprehensive effective regulatory scheme is well estab-

lished.[5] Commission responsibility in regulating producer rates through area ceilings has been delineated by this Court in *Permian*[6] and by the United States Court of Appeals For The Fifth Circuit in *Austral.*[7] In *Austral,* the Court stated:

> ". . . The FPC must evaluate each rate set against policies as broad as the Natural Gas Act itself. Colorado Interstate Gas Co. v. FPC, 324 U.S. 581, 605, 65 S.Ct. 829, 840, 89 L.Ed. 1206. The purposes of the Act encompass not only reasonably low rates but maintenance of adequate service for the consumer, and the latter objective is the reason for the *Hope* requirement that rates must be 'sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.' " (428 F.2d at 435, note omitted)[8]

Cost estimates have contributed as a point of departure for determination of producer rates in every area rate proceeding. All of these estimates postulate a common assumption—that royalty will be paid at the same rate obtained by the producer (see Appendix D, *infra,* pp. 108a, 109a). In the Presiding Examiner's Initial Decision on which

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5. *Phillips Petroleum Co. v. State of Wisconsin,* 1954, 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035; *Panhandle Eastern Pipe Line Co. v. Public Service Commission,* 332 U.S. 507, 68 S.Ct. 190, 92 L.Ed. 128.

6. *Permian Basin Area Rate Cases, 1968,* 390 U.S. 747, 88 S.Ct. 1344, 20 L.Ed.2d 312.

7. *Southern Louisiana Area Rate Cases, Austral Oil Co., et al. v. F.P.C.,* 428 F.2d 407 (5th Cir. 1970) *cert.* denied, *Municipal Distributors Group, et al. v. F.P.C.,* 1970, 400 U.S. 950, 91 S.Ct. 241, 27 L.Ed.2d 257.

8. The reference in this quote to "Hope" is to *F.P.C. v. Hope Natural Gas Co.,* 1944, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333.

Commission Opinion No. 562 was based,[9] the Examiner found that the price to be paid for royalty interests has a direct and substantial effect on the price paid by the ultimate consumer. The directness of this effect is evident from a comparison of the royalty interest with the other interests and claims created by the mineral lease and with the other obligations incurred by the producer. In no other instance are the claims measured by, and directly proportional to, the amount of production. In this respect the Court of Appeals was incorrect when it stated (Appendix A, *infra*, pp. 14a, 15a) that even in an interstate sale there was no interstate movement of gas connected to the royalty transaction. Before any royalty can be claimed there must be production and movement of gas, and the extent of the claim is measured directly by the amount of such production and movement.

The Presiding Examiner described the impact of the higher royalty claims as follows:

> "The consumer for whom the Natural Gas Act is designed to protect has a real interest in the amount paid for royalty, by reason of the royalty owners now attempting to force the payment for the royalty fraction to a higher rate than that named in filed rate schedules of the producer. The market price for gas, as can be expected, in the unregulated market is higher than allowed under regulation by the Commission. This is not only evidenced by the suits which gave rise to this proceeding but also as shown in the brief above referred to filed by the Old Ocean Royalty Owners Association. Therein it was pointed out that in 1966 over 88,000,000 Mcf of gas was taken

9. Presiding Examiner's Initial Decision On Jurisdiction Over Royalty Interests, Docket Nos. RI67-113, *et al.*, issued July 23, 1968, 42 FPC 187. Appendix C, *infra*, pp. 63a-87a.

from the Old Ocean Field of which over 41,000,000 was sold in interstate commerce to the Natural Gas Pipeline Company of America at 11.4 cents per Mcf and in excess of 47,000,000 Mcf was sold in intrastate commerce at higher prices.

"Considering the volumes of gas that move in interstate commerce and the uncertainty of the price to be paid for the royalty interest, which has a direct and substantial effect on the price paid by the ultimate consumer, the Commission must now exercise its jurisdiction to insure the reasonableness of price for gas to the consumer." (42 FPC at 195, 196; Appendix C, *infra,* pp. 82a, 83a)

In reviewing the evidence in this case, as it relates to the "additional" ground for jurisdiction, the Circuit Court appears to have left unheeded the findings of the Presiding Examiner. In so doing, the Court erred. *Universal Camera Corp. v. NLRB,* 1951, 340 U.S. 474, 71 S.Ct. 456, 95 L.Ed. 456. The Commission's Opinion No. 562 relies explicitly on the Presiding Examiner's Decision. (See Appendix B, *infra,* pp. 33a, 34a)

The record on which the Examiner and the Commission acted contained the testimony and exhibit of Mr. Don L. Jones (Certified transcript pages 1845-1850) describing the impact of the higher royalty claims on the Federal Power Commission's regulation of producer rates and illustrating the effect of market value claims on a producer's revenues. This evidence was also before the Court of Appeals in the Joint Appendix filed therein. The revenue reductions resulting from market value royalty claims affect producers in a manner inconsistent with the maintenance of adequate supplies. In Opinion No. 562, the Commission determined that regulation of such excess royalty claims was necessary in order to avoid that effect.

> ". . . The question of whether royalty payments are subject to our jurisdiction must be examined with the terms of the Natural Gas Act in mind together with the intent of Congress, in the passage of that Act, to assure an adequate supply at the lowest reasonable rates." (Appendix B, *infra* p. 35a)

This approach supports jurisdiction on a basis similar to that upheld in *United States v. Southwestern Cable Co.*, 392 U.S. 157 (1968), and in *American Trucking Associations v. United States*, 344 U.S. 298 (1952). In the *Southwestern Cable* case, F.C.C. jurisdiction over cable television was upheld even though cable television did not fit the precise language of the Communications Act.[10] In the *American Trucking* case, the I.C.C. was held to have jurisdiction over truck leasing even though the Motor Carrier Act[11] could not be read literally to cover leasing practices. In each case, however, the jurisdiction asserted was necessary to effectively carry out the expresed purposes of the respective regulatory statute. Even though this was an "additional" ground for asserting the Federal Power Commission jurisdiction, we submit that it has warrant in the record and rational basis in the law.

B. Where A Determination of Primary Jurisdiction Is Involved, The D. C. Circuit Should Not Reverse The F.P.C. If The Reason For Such Reversal Could Be Remedied On Remand.

As to the "additional" basis for jurisdiction found by the F.P.C., the Court of Appeals held that the underlying record should be "more comprehensive and profound—broader and deeper, as it were—than the findings and

10. 47 U.S.C. §152.

11. Part II, Interstate Commerce Act, 49 U.S.C. Chapter 8.

analysis presented on this record." (Appendix A, *infra*, p. 18a). Rather than remand the case to the Commission for the findings and analysis which the Court found lacking, the Commission's Opinion No. 562 was simply reversed, not only as to the first jurisdictional basis found by the Commission but also as to this second or "additional" basis.

The question of F.P.C. jurisdiction of royalty interests is one of national importance. The present crisis in the nation's supply of natural gas has received the recognition of the Courts and is receiving the continuing attention of the Federal Power Commission. The Fifth Circuit in *Austral*[12] referred to the "possibility, indeed perhaps a certainty, that the supply of gas is dangerously low." (428 F.2d at 437). More recently, the District of Columbia Circuit referred in *City of Chicago, et al. v. F.P.C.*,[13] to "the record information concerning the steady decline in the overall reserve-production ratio as well as the decline, both relative and absolute, in reserves of natural gas owned by pipeline companies." (slip opinion p. 28, note omitted). Faced with an unprecented number of pipeline curtailment cases, the Federal Power Commission has undertaken as a minimum objective "action to halt and hopefully to reverse the downward trend in the reserves-to-production ratio."[14] The downward trend was illustrated by a .51 to one finding-to-production ratio on a three year moving average (1968, 1969, 1970).

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12. *Southern Louisiana Area Rate Cases, supra.*

13. *City of Chicago, et al. v. F.P.C.*, _____F.2d_____, decided December 2, 1971 in Case No. 23,740 (CADC).

14. *Area Rate Proceeding, et al. (Southern Louisiana Area)*, Opinion No. 598, Docket Nos. AR61-2, *et al.*, AR69-1 issued July 16, 1971, _____FPC_____. (slip opinion p. 31).

In this context, a Commission finding of gas royalty jurisdiction based on a record considered inadequate by the Circuit Court should not be reversed without a remand to the Commission to develop the findings the Court deems essential. *Morand Bros. Beverage Co. v. NLRB*, 204 F.2d 529 (7th Cir. 1953); *cert.* denied 346 U.S. 909, 74 S.Ct. 241, 98 L.Ed. 407; rehearing denied 346 U.S. 940, 74 S.Ct. 376, 98 L.Ed. 428. *CAB v. American Air Transport, Inc.*, 201 F.2d 189 (D.C. Cir. 1952), certificate dismissed, 344 U.S. 4, 73 S.Ct. 2, 97 L.Ed. 4. *Pacific Far East Line, Inc. v. Federal Maritime Board*, 275 F.2d 184 (D.C. Cir. 1960), *cert.* denied 63 U.S. 827, 80 S.Ct. 1597, 4 L.Ed. 2d 1523. *Coffey v. Jordan*, 275 F.2d 1 (D.C. Cir. 1959).

In addition to the national importance of the question, there is a further cogent reason why the D. C. Circuit should have remanded. That reason lies in the fact that the Commission's determination was by way of response to the Fifth Circuit's referral in *J. M. Huber Corporation v. William Harvey Denman*, 367 F.2d 104 (5th Cir., 1966), where it was stated:

> "Thus we end, as we began, a consideration of these factors pro and con demonstrate that there is at least an arguable basis for FPC jurisdiction. Moreover, these factors ought first to be evaluated by the FPC in the resolution of the question of statutory power and, if that is found to exist, the necessary implementation of that in terms of the extent to which the exercise of that power is or will be appropriate. Lest we be misunderstood, we emphasize again that this analysis is merely to indicate why we conclude primary jurisdiction reference should be made, the Court all the while disclaims any purpose by what it has said or left unsaid, by its comments,

> express or implied, of declaring or intimating what its views are on the questions referred for initial decision by the FPC and the arguments pro and con." (367 F.2d at 120, 121; Appendix D, *infra* p. 118a)

The Fifth Circuit concluded its referral to the Commission with a test of the response expected:

> "For obvious reasons we do not undertake to blueprint the proceedings before the Commission. Nor, in specifying the specific subjects of inquiry and report, do we mean to foreclose other relevant, specific inquiries or variations thereof which might be developed in the proceeding and which will or might have a significant bearing upon the substantial public issue questions of great importance. Rather, the test should be: when the FPC rules and the reviewing Court enforces, will the decision likely supply the answers needed by the trial Court in determining precisely and to what extent matters are or are not for FPC determination and those reserved for court determination?" (367 F.2d at 121, note omitted; Appendix D, *infra* p. 119a)

The mandate to the Commission included the determination in the first instance whether, under the Natural Gas Act, it had jurisdiction over royalty interests which were claimed at rates higher than those to which the producers were entitled, and how such jurisdiction, if any, was to be implemented. The mandate required such issues be resolved on the basis of all the relevant factors enumerated by the Court as well as all other relevant, specific inquiries or variations which might be developed or which might have a significant bearing.

The fact that only one of two possible grounds for jurisdiction are involved in the remand does not diminish

the Circuit Court's responsibility to remand. *Michigan Consolidated Gas Co. v. F.P.C.* (1960), 283 F.2d 204, 108 U.S. App. D.C. 409, *cert. den.* 364 U.S. 913. Sound and expeditious judicial administration call for remand in order that the question of FPC jurisdiction on the "additional" basis may be resolved in this proceeding.

Assuming the correctness of the D. C. Circuit's decision that the record and findings need to be "broader and deeper" to support the Commission's holding, that Court has effectually held that the Commission, on this point, failed to meet the test set out by the Fifth Circuit in its referral. The remedy is for the Commission to supply the record and findings needed to resolve the issue, not for the Court to postpone its resolution to another case.

The D. C. Circuit's opinion suggests that in some future case a producer might invoke "the broad and supple doctrine of primary jurisdiction"[15] and bring the dispute between the royalty owner and the lessee-producer before the FPC on reference from the courts. The Court states:

> "The question would arise whether a decision requiring a producer to pay the royalty owner on a basis higher than his Federal ceiling would be interfering with his carrying on interstate commerce conformably with the conduct prescribed for the producer by the Federal regulatory agency." (Appendix A, *infra* p. 22a note 24.)

The multiplicity of proceedings and litigation which the D. C. Circuit seems to be suggesting is exactly what the Fifth Circuit was trying to avoid in invoking the doctrine

15. Appendix A, *infra*, p. 22a.

of primary jurisdiction in the *Denman* case and referring to the Federal Power Commission the responsibility of determining in the first instance its jurisdiction and the appropriate application thereof with regard to royalty claims at rates above those allowed the producer-lessee. If the Commission has fallen short of meeting the Fifth Circuit's mandate with particular regard to the "additional" jurisdiction basis, this case should be remanded in order that it may comply.

VII. Conclusion

The issue of jurisdiction over royalty claims is admittedly a new one for the Federal Power Commission as well as the courts. The importance of the question calls for finality in its resolution. This finality was required in the Fifth Circuit's mandate in *Denman*. Finality was the goal of the Commision in its Opinion No. 562. In failing, however, to remand this case, the D. C. Circuit has precluded a final determination of the issue of the Commission's jurisdiction of royalty claims at rates above those allowed a producer-lessee. If a "broader and deeper" record and finding will enable a determination of the issue, it should be done in this case, not in another. For this

reason this petition for a writ of certiorari should be granted.

Respectfully submitted,

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March 14, 1972

APPENDIX

APPENDIX A

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 23,463

MOBIL OIL CORPORATION, *Petitioner*

v.

FEDERAL POWER COMMISSION, *Respondent*

PANHANDLE EASTERN PIPE LINE COMPANY,
CARL F. MATZEN, ET AL.,
CITIES SERVICE OIL COMPANY,
PHILADELPHIA GAS WORKS DIVISION OF UGI
CORPORATION, *Intervenors*

No. 23,491

J. M. HUBER CORPORATION, *Petitioner*

v.

FEDERAL POWER COMMISSION, *Respondent*

PHILADELPHIA GAS WORKS DIVISION OF UGI
CORPORATION,
SHELL OIL COMPANY, *Intervenors*

No. 23,511

WESTERN NATURAL GAS COMPANY, *Petitioner*

v.

FEDERAL POWER COMMISSION, *Respondent*
PHILADELPHIA GAS WORKS DIVISION OF UGI CORPORATION,
CARL F. MATZEN, ET AL., *Intervenors*

No. 23,633

AMOCO PRODUCTION COMPANY, *Petitioner*

v.

FEDERAL POWER COMMISSION, *Respondent*

PHILADELPHIA GAS WORKS DIVISION OF UGI CORPORATION,
CARL F. MATZEN, ET AL., *Intervenors*

No. 23,654

THE LAND AND ROYALTY OWNERS OF LOUISIANA, *Petitioner*

v.

FEDERAL POWER COMMISSION, *Respondent*

MOBIL OIL CORPORATION,
PHILADELPHIA GAS WORKS DIVISION OF UGI CORPORATION,
Intervenors

No. 24,051

CARL F. MATZEN, ET AL., *Petitioners*

v.

FEDERAL POWER COMMISSION, *Respondent*

MOBIL OIL CORPORATION,
PHILADELPHIA GAS WORKS DIVISION OF UGI CORPORATION,
CITIES SERVICE OIL COMPANY,
PANHANDLE EASTERN PIPE LINE COMPANY,
ATLANTIC RICHFIELD COMPANY,
WESTERN NATURAL GAS COMPANY,
SHELL OIL COMPANY, *Intervenors*

No. 24,180

WILLIAM HARVEY DENMAN, ET AL., *Petitoners*

v.

FEDERAL POWER COMMISSION, *Respondent*

CITIES SERVICE OIL COMPANY,
PANHANDLE EASTERN PIPE LINE COMPANY,
PHILADELPHIA GAS WORKS DIVISION OF UGI CORPORATION,
SHELL OIL COMPANY,
J. M. HUBER CORPORATION, *Intervenors*

Petitions for Review of Order of the
Federal Power Commission

Decided December 17, 1971

Mr. Carroll L. Gilliam, with whom *Messrs. Philip R. Ehrenkranz* and *William H. Emerson* were on the brief, for petitioners in Nos. 23,463, 23,511 and 23,633; also argued for intervenor Cities Service Oil Company in Nos. 23,463, 24,051 and 24,180. *Mr. William J. Grove* entered an appearance for petitioner in No. 23,633.

Mr. Sherman S. Poland, with whom *Messrs James B. Reed* and *Daniel F. Collins* were on the brief, for petitioner in No. 23,491 and intervenor J. M. Huber Corporation in No. 24,180.

Mr. Dale M. Stocky for petitioners in No. 24,051 and intervenors Carl F. Matzen, et al., in No. 23,463, 23,511 and 23,633.

Mr. H. H. Hillyer, Jr., for petitioner in No. 23,654.

Mr. Israel Convisser, Attorney, Federal Power Commission, with whom *Messrs. Gordon Gooch,* General Counsel, *Leo E. Forquer,* Assistant General Counsel, Federal Power Commission, and *Peter H. Schiff,* Solicitor, Federal Power Commission at the time the brief was filed, were on the brief, for respondent.

Mr. Dan A. Bruce, with whom *Mr. Thomas G. Johnson* was on the brief, for intervenor Shell Oil Company in Nos. 23,491, 24,051 and 24,180.

Mr. Graydon D. Luthey was on the brief for intervenor Cities Service Oil Company in Nos. 23,463, 24,051 and 24,180.

Mr. Charles E. McGee was on the brief for intervenor Atlantic Richfield Company in No. 24,051. *Mr. John T. Ketcham* also entered an appearance for intervenor Atlantic Richfield Company in No. 24,051.

Mr. James J. Flood, Jr., entered an appearance for intervenor Panhandle Eastern Oil Company in Nos. 23,463, 24,051 and 24,180.

Before LEVENTHAL, ROBINSON and MACKINNON, *Circuit Judges.*

Opinion for the Court filed by LEVENTHAL, *Circuit Judge.*

Concurring opinion filed by MACKINNON, *Circuit Judge,* at p. 26.

LEVENTHAL, *Circuit Judge:* These are petitions for review of an order of the Federal Power Commission (FPC), accompanied by its opinion No. 562, 42 FPC 164, which determined and declared that the royalty provisions of oil and gas leases constitute sales of natural gas for resale in interstate commerce subject to the Natural Gas Act, and that the landowners are subject to regulation as natural gas companies whose sales are covered by the filings of their lessees, the producer-operators. We reverse.

Facts and Prior Proceedings

In *J. M. Huber Corp. v. Denman,* 367 F.2d 104 (5th Cir. 1966), the court agreed with landowners that the particular oil and gas leases they executed required the gas-producer lessees to make royalty payments based on the current "market price" of the gas and not, as lessees contended, on the actual price received by the producer for the gas.

The market price was not determined because the lessor's claim, for a royalty based on a market price of 23¢ per mcf for gas run since 1946, presented "a serious question whether a Court, state or federal, either intially or ultimately, may allow any amounts fixed by jury, court, or both as increased royalty payments without express prior approval of the Federal Power Commission

if, as would these, the price thus fixed would exceed levels prescribed by the FPC." (367 F.2d at 110, 111.) The court took account of the public interest issues involved, and directed a reference by the parties to the FPC under the doctrine of primary jurisdiction for that agency to make an initial determination of its jurisdiction over rates to be paid for gas royalty.

Thereafter the royalty owner-landholders in *Huber* petitioned the FPC for a declaratory order disclaiming jurisdiction over royalty payments. Several lessee-producers involved in similar litigation filed complaints seeking an FPC determination that such royalties are subject to FPC jurisdiction. The FPC consolidated the dockets for hearing and decision. After prehearing conferences and evidentiary hearings, the presiding examiner concluded that the royalty owners are "natural gas companies as defined in the Natural Gas Act"[1] and that a royalty owner seeking an increase in royalty payment must apply to the FPC beforehand. The Commission affirmed in part by a vote of 3-2. It declared that "the royalty provisions of oil and gas leases constitute sales of natural gas for resale in interstate commerce subject to all the provisions of the Natural Gas Act."[2] However, it held that the royalty owners need not make a separate filing to the FPC; the producers' filings were held to cover the royalty "sales" adequately for regulatory purposes.[3]

Petitions to review have been filed both by Mobil Oil Corporation and other producers, and by royalty owners, and the cases have been consolidated. The royalty

1. R. 4459; 42 FPC at 198.

2. R. 5045; 42 FPC at 174.

3. *Id.*

owners challenge the FPC's jurisdictional decision. The producers challenge the contemporaneous ruling, referred to in more detail hereafter, that the royalty owners are entitled to payment on the basis of their contract terms even when higher than the producer's effective rate, provided no breach of ceiling prices is wrought. We find error in the jurisdictional determination.

Ruling That The FPC Does Not Have Jurisdiction Over The Payment Of Royalties Under A Typical Natural Gas Lease

In the FPC's order of June 23, 1967, setting a hearing on whether royalty payments to the lessors are subject to its jurisdiction, the Commission authorized receipt of evidence relating to general industry contracting practices with respect to gas leases so as to be more fully informed as to the general background of the problem and possible economic and legal consequences before making its determination.

Evidence was introduced on industry practice with respect to oil and gas lease agreements. The evidence is well summarized in the opinion of the Presiding Examiner. He focused on the development wherein the landowner has sometimes reserved a royalty of a percentage of the physical hydrocarbon recovered (for oil), has sometimes reserved a royalty of a percentage of the proceeds thereof, and has sometimes reserved a royalty of a percentage of the "market value" thereof at the well or in the field. This portion of the Examiner's opinion provides useful background information and is set forth in an Appendix to this opinion.

The Commission found one "basic fact" determinative of the jurisdictional issue: "the effective retention by the royalty holders of a percenage interest in the gas sold in interstate commerce." This led to the conclusion "that

if he has contracted to retain an economic interest in interstate sales, he has joined the other interest owners in such sales and he has become a seller of natural gas and therefore a natural gas company."[4]

For jurisdiction to attach under the Natural Gas Act, the royalty owners must be held engaged in a "sale in interstate commerce of natural gas for resale." Section 2(6) of the Act defines a "natural gas company" to mean "a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale."[5] Section 1(b) of the Act provides, 15 U.S.C. §717(b):

> "The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas."

Whether landowners or other royalty owners are engaged in the "sale" of natural gas in interstate commerce for resale within the meaning of §1(b) of the Act must be determined by reference to the intention of Congress.

The Act was passed in 1938 and it has not heretofore been construed to apply to ordinary lessors. While inaction is not controlling on intent, the widespread assumption and acquiescence therein, including administrative

4. 42 F.P.C. at 172.

5. 15 U.S.C. § 717a(6).

and legislative acquiescence, extending over such a great period of time is not lightly to be brushed aside.

The intention of Congress cannot be conclusively determined by reference to concepts and classifications under state law decisions normally disposing of "private" controversies. *United Gas Improvement Co. v. Continental Oil Co.*, [the *Rayne Fields* case] 381 U.S. 392, 400 (1965).[6]

It must ultimately be ascertained in the light of regulatory purpose and objective. But as a point of departure we may properly begin with the presumption that Congress, like other legislatures, has in mind the ordinary, usual, and natural sense of a word like "sale."[7] This canon is given reinforcement for this term because "sale" was not one of the terms for which Congress provided an express or supplemental definition in § 2 ("Definitions") of the Natural Gas Act.[8]

We have no need to pursue the intricacies of oil-and-gas law, or to take note of the way in which state law concepts vary in describing the interests created by oil and gas leases.[9] It suffices for this case that generally

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6. Certainly Congress did not intend to create a state checkerboard of federal regulation and non-regulation depending on the varying concepts under local law of the leaseholder's interest.

7. McNally v. Hill, 293 U.S. 131 (1934); see Old Colony RR v. Comm'r, 284 U.S. 552, 560 (1932).

8. 15 U.S.C. § 717a.

9. Among the classifications found by one text writer, with numerous citations to each one (omitted here) are: profit *a prendre*, corporeal hereditament, incorporeal hereditament, an estate in land, not an estate in land, an estate in oil and gas, not an estate in oil and gas, a servitude, a chattel real, real estate, interest in land, not an interest in land, personal property, a freehold, a tenancy at will, property interest, and the relation of landlord and tenant. 1A W. SUMMERS, LAW OF OIL AND GAS § 152 at 371-374 (2d ed. 1954).

the royalty owner is not considered, either in common parlance or in conceptions of state law decisions, to be engaged in any "sale" of gas.[10] As to state law we refer to Judge Brown's discussion in *Huber*.[11] The lease terms give the lessee all possessory interests in gas produced during the life of the lease, including full right of sale.

The general understanding of lack of any "sale" by the royalty owner, an understanding rooted in state law concepts, is underscored by the opinion in *Burnet v. Harmel*, 287 U.S. 103 (1932) decided only a few years before passage of the Natural Gas Act. While that opinion interprets a tax statute, there is pertinence in Justice Stone's discussion of the lack of incidents of a "sale" by the royalty owner, both in technical terms and common understanding. See 287 U.S. at 107:

> [T]he statute speaks of a "sale," and these leases would not generally be described as a "sale" of the

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He concludes, "Perhaps sometime courts and legislatures will recognize the fact that oil and gas leases are different from other forms of contracts and conveyances, and that the interests created by them cannot be properly classified under common interests in property, and will speak of such interests as the interest of an oil and gas lessee. . . ." *Id.* at § 153, p. 382.

10. We put to one side any special case of a landowner who takes a share of the gas produced as his royalty and resells it.

11. See 367 F.2d at 113-114:

> "[The lessors make] the very simple, yet profound, contention that there can be 'sale' of gas by royalty owners since they have no gas to sell. And this seems to be true as a matter of oil and gas law, whether based on the ownership-in-place concept followed by Texas and others or on non-ownership theories of other jurisdictions. For all agree that as the gas leaves the well-mouth, the entire ownership of the gas is in the lessee, none being reserved in the lessor."

Judge Brown's citations reveal that even in Texas, where a lease constitutes a present sale of all the gas in place, the royalty owner possesses some property right in the minerals.

> mineral content of the soil, using the term either in its technical sense or as it is commonly understood. Nor would the payments made by lessee to lessor generally be denominated the purchase price of the oil and gas. By virtue of the lease, the lessee acquires the privilege of exploiting the land for the production of oil and gas for a prescribed period; he may explore, drill, and produce oil and gas if found. Such operations with respect to a mine have been said to resemble a manufacturing business carried on by the use of the soil, to which the passing of title of the minerals is but an incident, rather than a sale of the land or of any interest in it or in its mineral content. *Stratton's Independence v. Howbert*, 231 U.S. 399, 414, 415; see *Von Baumbach v. Sargent Land Co.*, 242 U.S. 503, 521.[12]

The Court referred to its rule of long-standing, that "payments by lessees to lessors under mining leases were not a conversion of capital, as upon a sale of capital assets, but were income to the lessor, like payments of rent." *Id.* at 108.

The FPC's opinion stated "it would be senseless to attempt to determine what is a natural gas company and what is a sale on the basis of Hornbook definitions or local decisions not applicable to the Natural Gas Act. . . . For purposes of the Act, a 'natural gas company' is engaged in 'the sale in interstate commerce of [natural] gas for resale' but whether his operations would be classified

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12. Von Baumbach v. Sargent Land Co. is one of the Minnesota Royalty Cases involving state leases of iron ore lands. The leading case thereon points out that mineral leases were developed under the law of tenancy and not through the law of sales. Thus the miner never got his title to his mineral through a sale by the owner but rather as a product of the use for which rent was paid and title was acquired by an appropriate use of the leased premises. State v. Evans, 99 Minn. 220, 108 N.W. 958, 906 (1906).

as a 'sale' under private law is not determinative, *U.G.I. v. Continental Oil Co.*, 381 U.S. 392." (R. 5041).

In *UGI v. Continental Oil Co., supra,* referred to as the *Rayne Field* case, the Supreme Court extended FPC jurisdiction over sales of certain leases, although the Act addresses itself, in terms, to sales of gas. Sound analysis of that case requires development of its background.

In *Phillips Petroleum Co. v. Wisconsin,* 347 U.S. 672 (1954), the Court held that FPC had jurisdiction over "well-head" sales of natural gas by independent producers to interstate pipeline companies for resale in interstate commerce. As the *Phillips* opinion made clear (347 U.S. at 677) the producers admitted "as they must" that they were engaged in "the sale in interstate commerce of natural gas for resale" and hence came within the basic coverage of § 1(b). The issue was whether the sales of an independent producer were excluded from regulation by the ultimate, and negative, clause of § 1(b) excluding "the production or gathering of natural gas." The Court rejected the contention of exclusion, in view of the Act's text and legislative history, including notably the Federal effort to plug the "gap" in regulation of the natural gas industry created by decisions prohibiting state regulation of interstate commerce aspects. The Court found "a congressional intent to give the Commission jurisdiction over the rates of all wholesales of natural gas in interstate commerce, whether by a pipline company or not and whether occurring before, during, or after transmission by an interstate pipeline company."[13]

In *Rayne Field,* an interstate pipeline company made arrangements to buy the producers' leasehold interests

13. See 347 U.S. at 682.

in the lands in which the natural gas was located, instead of buying the gas produced directly. The gas reserves in Rayne Field were proven and the field was substantially developed. The Court noted "The provisions of the lease-sale agreements were such that they were very close in economic effect to conventional sales of natural gas." (381 U.S at 396). The Court concluded (p. 401):

> "The sales of leases here involved were, in most respects, equivalent to conventional sales of natural gas which unquestionably would be subject to Commission jurisdiction under *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672. . . . [I]t is perfectly clear that the sales of these leases in Rayne Field, a proven and substantially developed field, accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other States. That is the significant and determinative economic fact. To ignore it would substantially undercut *Phillips*. . . .[14]

It is in this context, of a transaction that was in form a lease of reserves but in economic impact the equivalent of "conventional sales of natural gas" that the Court, in upholding FPC jurisdiction to avoid "gaps" in the regulatory framework, stated (381 U.S. at 400):

> "A regulatory statute such as the Natural Gas Act would be hamstrung if it were tied down to technical concepts of local law." *Rayne Field, supra*, 381 U.S. at 400.

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14. The FPC's decision in *Rayne Field* observed that it "would exalt form over substance, would give greater weight to the technicalities of contract draftsmanship than to the achievement of the purposes of the Natural Gas Act, and would impair our ability to control the price received for gas sold to the pipelines in interstate commerce to the detriment of the ultimate consumer" to hold that it had no jurisdiction. 29 FPC 249, 256, *quoted at* 381 U.S. at 398.

These opinions were written with full awareness of the significance, in commercial and regulatory terms, of the sales of gas by independent producers to interstate pipeline companies. In establishing a Congressional intent to regulate those sales the Court began, in *Phillips* with what were plainly and admittedly "sales in interstate commerce of natural gas." This was fortified when *Rayne Field* extended coverage to producers' sale of their leases to interstate pipelines, for that extension was on the ground that these lease transfers were the equivalent "in economic effect to the concept of conventional sales" and such conclusion was required so as not to open gaps in Federal regulation. In both cases the Court did not undercut, it rather underlined, the need for a jurisdictional foundation in "sales in interstate commerce"—plain and admitted in *Phillips*, and existing through economic equivalent in *Rayne Field*.

When we come to an ordinary lease by the landowner to the producer there is neither a "customary" sale in interstate commerce nor its equivalent in economic effect. Such a lease is a transaction that is itself customary and conventional, but one that precedes the "conventional" sales in interstate commerce with which Congress was concerned, indeed even precedes the "production and gathering" which § 1(b) visualized as preceding the sale in interstate commerce over which jurisdiction was being established.

Turning to the "significant and determinative economic facts," basically the significant fact for a sale in interstate commerce is interstate movement either by the seller, prior to or in connection with the sale, or by the purchaser, typically an interstate pipeline company, subsequent to or in connection with the sale. In the case of a

typical oil and gas lease, there is no such interstate movement by either the transferor or transferee.

In *Rayne Field*, the gas reserves were known and had been substantially developed by or in behalf of the lessees-producers. A gas lease, however, transfers only the right to explore, develop, and market if exploration is successful; no royalty is paid if no gas is discovered. In *Rayne Field* the lease-buyers were interstate pipeline companies —clearly "natural gas companies" under the Act—and it was known that the gas was destined for interstate commerce. As to leases of reserves from landowners to lessee-producers there is no knowledge when the lease is executed of the ultimate destination of any gas that might be discovered,[15] no knowledge whether the gas, if discovered, will be sold either to an interstate pipeline or to any other customer that will move it across state lines. While the lease by the landowner provides for a royalty in the event of the discovery and sale of gas, typically he has no control over any incident of such sale either as to the quantity to be sold, the price to be paid, the identity of the purchaser or whether it shall be sold in interstate or intrastate commerce. To refer to the royalty owner as engaging in the sale is to depart from the common understanding of the words used, industry parlance, economic equivalent, or any other foundation hitherto considered a source for discerning Congressional intention.

The Commission's approach was this, that when a landowner executes a "proceeds" or "value" lease "he has contracted to retain an economic interest in interstate

15. The producer is a natural gas company because of the interstate movement conducted either by him or by his customer, assuming he discovers gas and makes a sale in interstate commerce.

sales by the producer," and "has joined the other interest owners in such sales and he has become a seller of natural gas."[16] But an economic interest in the proceeds of a sale, unaccompanied by authority to determine the incidents of the sale, does not make one a seller. The developer of a shopping center does not become a seller of food because he leases to a supermarket on percentage rental terms. A patentee who licenses various manufacturers on a royalty percentage basis is not generally considered the seller of the articles. Nor does the lessor become a seller of an article merely because the article was produced on or from the land that he leased. An owner of farmland leased to a farming tenant does not become a seller of produce raised because his rent may be a fraction of the price received for the crops. An owner of a mine leased to an operator does not become a seller of the ore produced because the stipulated compensation for the lease is a fixed fraction of the price received for the ore produced.

If the statutory use of "seller" or "sale" of natural gas in interstate commerce is referable to the meaning of these words in ordinary usage, or as likely understood by Congress, the FPC's ruling is clearly unsound. We do not think a different result warranted or mandated on the ground that the purpose of the Act is to protect the ultimate beneficiaries against exploitation by natural gas companies. That was indeed the objective of Congress, see *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 610 (1944). The FPC is to be commended for attempting to further that objective, but it is not sufficient justification upon which to base an expansion of the Act to activities clearly not within its terms. Congress did not

16. R. 542, 42 FPC at 172.

give the FPC carte blanche to take whatever action it might consider appropriate in furtherance of this purpose. The FPC is limited by the provision establishing its jurisdiction, and we do not find in that provision, rooted as it is in a sale in interstate commerce, any basis for reaching out to cover the landowner's lease or its royalty payments. We think it too far removed from the interstate sale. When there is a sale of gas to a pipeline in interstate commerce, the FPC will of course have the jurisdiction and the responsibility to exercise control in the interest of the ultimate consumer.

We turn to a consideration of what may be implied as to jurisdiction from the requirement of effective Federal regulation of producers and pipelines. Of course for leases executed after this controversy took shape, it seems probable that producers will be able, and indeed have been able, to insist on leases drafted so as to avoid recurrence of the present controversies.

More significantly, the FPC's jurisdiction over rates chargeable by a producer includes authority to determine the reasonableness of costs incurred, even though these are not subject to direct FPC control, and that establishes authority to review royalty payments, or drilling rig rentals, or any other element of the producer's cost of service.[17] *Permian Basin Area Rate Cases*, 390 U.S. 747, passim and at pp. 824-25 (1968). And we interject that this is the only approach that even the FPC has in mind for handling other elements of the total payments made

17. In the Permian Basin area rate decision, eventually sustained by the Supreme Court, the FPC calculated the average cost of producers affected, as to royalty payments, on an assumption of 12½% of total cost of service (including return on capital). FPC opinion No. 468, 34 FPC 159 at 192 (1965).

by producers to landowners, *e.g.*, the cash bonus, delay rentals.

Intervenor Shell Oil Co. put forward the contention that jurisdiction should rest on the burden created on interstate commerce by allowing royalty payments in excess of producers' rates. The Commission opinion stated that "since we find that an actual sale for resale by an interest owner does take place under the royalty provisions of the mineral leases the argument of Shell and Tenneco constitute an additional, but not the basic, reason for asserting jurisdiction."[18]

If an interpretative ruling stretching the Act as written to cover leases by landowners is to be countenanced on the score of necessity, and we do not say this will be possible, the underlying record must be more comprehensive and profound—broader and deeper, as it were—than the findings and analysis presented on this record. The case as it comes before us, with a cursory "makeweight" reference to a possible theory of economic burden, is in a wholly different posture from that presented in *United States v. Southwestern Cable Co.*, 392 U.S. 157 (1968), which held CATV systems to be within the Federal Communications Act's coverage of "all interstate and foreign communication by wire or radio", 47 U.S.C. § 152(a), and relied significantly on the FPC's finding that achievement of its regulatory purposes would be placed in jeopardy by the unregulated growth of CATV.

As to the problem of economic burden and higher prices for consumers although the record contains evidence and findings concerning different forms of industry contracts

18. 42 F.P.C. at 172, 173, R. 5043.

(see Appendix) we have no findings concerning the extent or significance of market price contracts. And the FPC's opinion gives no concrete indication of whether, in what circumstances, or to what extent, there may be an economically meaningful problem of "market prices" in excess of ceilings. In the *Huber* case the judgment entitling the royalty owners to pursue their claim made no determination of amounts of recovery. Apparently such litigation may come to involve substantial sums even if pursued so as to recover royalties based on ceilings higher than filed rates. This we infer from the fact that Mobil Oil and other producers have appealed from the ruling of the FPC that although the royalty owners' filing obligations are met by virtue of the filings made by the producers,[19] a royalty owner is not limited to the rate filed by the producer and may enforce his contract as calling for a higher rate if permitted by the Act.[20] The record simply does not focus on what may be involved in the possibility of recovery of royalty calculated on the basis of "market prices" higher than ceilings.

19. The FPC stated (42 FPC at 173, R. 5043) that by operation of the law the "jurisdictional royalty interest has in effect been covered by the producer filing since 1954, on the same theory as a producer's filing covers the interests of all non-signatory parties, and should continue to be so covered. Therefore the FPC concluded no amendment or extension of existing rules was needed.

20. "Where he [the royalty owner] has contracted for the market price or value it would appear that he has contracted for a payment equal to the maximum rate for such gas which could have been received [by the producer] as fixed under the law by this Commission. . . . Where no just and reasonable rate has been fixed and the producer has agreed to pay the royalty interest owner more than he himself receives for the gas, we believe that the basis of the effective rate [the rate filed by the producer] subject to adjustment when the just and reasonable rate is determined." 42 FPC at 174.

Questions have come to our mind concerning the FPC's theory as to how the royalty owners may be shoe-horned into the existing regulations, and we at least have it in mind that if the FPC's assertion of jurisdiction over royalty owners were sustained its regulatory problems might be more complicated than it has assumed.[21] To avoid any misunderstanding we interject that we have not been made uneasy by the contentions the producers have presented to us,[22] for we see no theoretical impediment to

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21. We are puzzled by the FPC conception that royalty owners are, and have since 1954 been, natural gas companies under the Act, limited under § 4 of the Act to their rates as filed, even though they have not made filings and indeed could not have made filings, and by the corollary conception that the royalty owners are deemed covered by the filings made by the producers yet may now sue the producers for a higher basis.

It is one thing to consider a non-signatory represented by the signatory when they have a common interest. But as we see it the reason why the FPC is asserting jurisdiction over the royalty owner is to handle the situation of a controversy between royalty owner and producer, and we are at least uneasy with an analysis whereby the royalty owner makes his filing by incorporation within the producer's filing and yet is free to seek a higher basis. If the royalty owners should recover on a basis of a market value higher than the rate that was filed by producers, it is difficult to discern how they may be deemed in compliance with the obligation of natural gas companies, for any sale subject to the jurisdiction of the FPC, to charge only the rate that is set forth in a public schedule filed with the Commission. It seems clear that the provisions of the regulations do not fit lessors.

We are also uneasy with the FPC's assumption that there can be no controversy between the landowner and the producer if an area ceiling is established. As we understand it the royalty owner was not, and apparently could not have been, a party to the area rate proceeding. If this is correct, it is not easy to see on what basis he can be held concluded by what has been established in such a proceeding, whether on conventional findings, or following a settlement.

22. They complain that they are made subject to immediate contingent liabilities to make retroactive royalty payments if the FPC authorizes area rates higher than those previously filed by the producers even though the producers are prohibited from retroactively adjusting their rates.

producers' being held on the basis of a contract to a royalty payment related to a base higher than the producers' filed rate. *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956). The producers make no claim, even obliquely, that they face financial or other difficulties requiring relief from contractual obligations, see *Permian Basin Area Rate Cases, supra,* 390 U.S. at 822, and insofar as general equitable considerations are concerned we suppose the FPC may have had in mind that its area ceilings are predicated on an assumption of royalty costs at a conventional fraction of ceiling prices (see note 17, *supra*).

In any event we are not persuaded that the maintenance in either state or Federal courts of contract (lease) controversies between royalty owners and lessees will undercut the Federal regulatory system. The controversies hitherto delineated by the private parties have focused on the producers' assertion of the need of the royalty owners to abide by the producers' filings and receipts. The problem of relationship of market prices to producer ceilings presents different considerations.

Without purporting to rule on the matter in any way, we can certainly visualize the possibility that a court confronted with a contention of entitlement to a market price basis higher than the producer's ceiling would consider it to run counter to the intention of the parties, unless there is something to rebut the fair presumption that they contemplated interstate movement and market prices compatible therewith.[23] The court might also consider that this

23. Compare Permian Basin Rate Cases, *supra*, 390 U.S. at 792 et seq., upholding departure from field prices in the public interest on the ground, inter alia, that various significant increases in field prices were "symptomatic of the deficiencies of the market mechanism."

result would be in furtherance of the general principle against application of contracts so as to contravene public policy, whether or not the result would be in violation of supremacy clause doctrine prohibiting state rules or decisions that require a regulated company to take action inconsistent with Federal regulation, see *Northern Natural Gas Co. v. State Corp. Comm. of Kansas*, 372 U.S. 84 (1963).[24]

The court handling the contract clause could avoid becoming embroiled in the ascertainment of the Federal ceiling by referring that issue to the FPC, invoking the broad and supple doctrine of primary jurisdiction, see *J. M. Huber Corp. v. Denman, supra*, 367 F.2d at 111; *cf. Brawner Building Inc. v. Shehyn*, ____U.S. App.D.C.____, 442 F.2d 847 (1971).[25] This would bring the FPC into the dispute between the royalty owner and the lessee-producer, but the FPC would be acting properly, on reference from the courts, rather than unduly stretching its jurisdiction and the statutory mandate to extend to royalty owners.

Special Circumstances of Denman "R" Lease

While Commissioners Carver and O'Connor wrote strong dissenting opinions from the assertion of jurisdiction over the royalty interest in most gas leases, they agreed with the majority that variations in the Denman "R" lease

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24. The question would arise whether a decision requiring a producer to pay the royalty owner on a basis higher than his Federal ceiling would be interfering with his carrying on interstate commerce conformably with the conduct prescribed for the producer by the Federal regulatory agency.

The question might be obviated in a particular case if the court discerned an intrastate market, capable of absorbing the volumes involved, not subject to any Federal ceiling.

25. The producer could file for a declaration of ceiling, with notice to the royalty owner as party affected.

rendered its royalties jurisdictional. Commissioner Carver found that the circumstances show "the lessor clearly identified his interests with those of the lessee-producer. The privity found lacking in the usual and normal leasing arrangement is supplied under this particular facts."[26] We do not consider this matter, as we do not know whether a majority of the FPC would have taken the same approach initially, or would wish to do so in the wake of our decision.[27]

Reversed.

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26. R. 5057, 42 F.P.C. at 183.

27. Braniff Airways, Inc. v. CAB, 126 U.S. App. D.C. 399, 379 F.2d 453 (1967).

APPENDIX

Excerpts from Opinion of Presiding Examiner, see 42 FPC at 190, 191:

> Every provision in a lease is open to negotiation, but not every provision is actually negotiated in every transaction. The most common items of negotiation between the lessor and prospective lessee are the amount of cash bonus, the amount of delay rental, the length of the primary term, and the royalty fraction.
>
> The cash bonus is the cash consideration paid by the lessee to the lessor for granting the mineral lease and may range from a minimal amount to a substantial sum.
>
> The delayed rental is a payment for the privilege of deferring the commencement of drilling operations or the commencement of production.
>
> The primary term is the term of the lease during which the lease may be continued in effect without drilling operations or production by the payment of a delayed rental.
>
> * * *
>
> The landowner may create by grant or by reservation various estates in land. The interest we are concerned with here is called royalty and is created by a reservation in an oil and gas lease in which the landowner grants to the lessee certain rights and privileges, such as, to explore, drill and produce oil and gas, and in the same instrument reserves to himself, free from the expenses of production, a share in the oil and gas produced or the proceeds thereof. Williams and Meyers, *Oil and Gas Law*, Manual of Terms, 342; Volume 1, sec. 202, 202.1, 202.3. This share is usually expressed in terms of a fraction of the production. The fraction is generally one-eighth and in some instances a larger amount. The royalty interest as to oil produced is usually taken in kind,

but as to gas produced, while the right to take in kind may be reserved, it is seldom done as a practical matter due to its characteristics and the lack of market other than the pipeline to which the lessee delivers the gas. The common provisions in the leases for accounting to the lessor for royalty as to the gas produced provide for the lessee to pay the lessor for his fractional part the market value in the field or a percentage of the proceeds derived from the sale of the gas.

In addition to the lessor's royalty interest, there is also another type of royalty interest called an overriding royalty interest. Such interest is most commonly created when a lessee enters into a farm-out agreement with another producer. In such an agreement the lessee retains either an undivided interest in the leases or an override interest. Both the lessor royalty interest and the overriding royalty interest as a contractual matter receive their respective interests free of any of the costs of production, except for taxes. The working interest owners generally share the expenses of development and operation of the property, proportionate to their interest in the property. Although the overriding royalty interest owner is a bare holder of a right to receive proceeds, the lessor royalty interest owner is protected by certain implied covenants with respect to the development of a lease and the marketing of the product.

* * *

In Docket No. RI67-113, there are involved three leases as to mineral rights in Texas, designated as the "R Lease" entered into on June 2, 1936, the "B Lease" and the "M Lease" on January 22, 1926. The royalty provision insofar as necessary for consideration here, under the "R Lease" which accounts for 93 percent of the production of gas provides for Huber, the leasee:

> To pay the Lessors monthly for one-fourth (¼) of the gas produced at the mouth of the well from any gas well, where gas only is found, four cents per one thousand cubic feet for the first ten years of this contract, and thereafter, the market price of such gas but in no event shall the price be computed at less than four cents per one thousand cubic feet.

Under the B and M Leases the royalty clause provides:

> To pay the Lessor the equal one-eighth part of the market value in the field for the gas from each well where gas only is found, while the same is being used off the premises, * * *

The type of lease varies as to mineral rights in Kansas under Docket Nos. RI67-114, RI67-310 and RI67-400. The royalty clauses in the leases here necessary for consideration generally provide for the lessee to pay the lessor on gas marketed from each well where gas only is found one-eighth of the proceeds if sold at the well, or if marketed by the lessee off the premises, then one-eighth of its market value at the well. Some of the leases set forth only a proceeds type royalty clause and others only a market type royalty clause. Regardless of the type of royalty clause set forth in the leases involved in these proceedings, the landowners claim entitlement at the market price.

MACKINNON, *Circuit Judge*, concurring: I agree with the result and with the opinion insofar as it decides issues in this case. However, with respect to future cases that might involve the relationship of market prices to producer ceilings, I see no necessity to discuss the effect of the intent of the parties, public policy, federal supremacy, or the use of primary jurisdiction.[1]

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1. *See* majority opinion, pp. 21-23, inclusive.

APPENDIX B

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

JURISDICTION (Royalty Owners)

Before Commissioners: Lee C. White, Chairman; L. J. O'Connor, Jr., Carl E. Bagge, John A. Carver, Jr., and Albert B. Brooke, Jr.

Docket Nos. RI67-113, *et al.*

WILLIAM HARVEY DENMAN, Trustee, *et al.*
v.
J. M. HUBER CORPORATION, *et al.*

OPINION NO. 562
OPINION AND ORDER DETERMINING JURISDICTION

(Issued July 23, 1969)

WHITE, Chairman:

INTRODUCTION

This proceeding arose following a decision of the United States Court of Appeals for the Fifth Circuit in *J. M. Huber Corp. v. William Harvey Denman, Trustee, et al.*, 367 F.2d 104 (1966). That case involved a claim by Denman as a royalty holder that under the terms of his lease with Huber he was entitled to a royalty payment based on up to one-fourth of a market value of 23 cents per Mcf for gas sold by Huber in interstate commerce at prices ranging between 4 cents and 11 cents.

The District Court found in favor of the royalty owner and on appeal the Circuit Court agreed that the royalty owner was entitled to the market price under the terms of his contract. However, the Circuit Court also found a serious question as to whether any court may allow increased royalty payments without express FPC approval if the result is to fix royalties on the basis of market prices in excess of the price the lessee-producer was authorized to charge pursuant to valid FPC regulation. The Court concluded that the FPC should make an initial determination of its jurisdiction over royalty payments. In referring the issue to the Commission the Court requested a ruling by the FPC:

> "(a) as to the jurisdiction of the FPC over payment for royalties for gas sold for resale and transport in interstate commerce, (b) the status of a royalty interest owner's transaction as a *sale* under the Act where incident to a sale for resale and transportation in interstate commerce, (c) the status of the royalty interest owner's transaction in this case as a *sale* under the Act."

Thereafter, Denman petitioned the Commission for an order disclaiming jurisdiction over the amount of royalties payable under the terms of the oil and gas leases involved. Mobil Oil Corp., Western Natural Gas Co. and Pan American Petroleum Corp. also filed complaints requesting a Commission determination that certain royalty payments arising out of some of their jurisdictional sales were jurisdictional. The Commission consolidated these complaints and in setting a hearing limited the issues in the following terms:

> "The hearing in these cases shall be confined to resolving whether the Commission has jurisdiction

over a landowner's royalty interest in natural gas leaseholds and, if answered in the affirmative, how such jurisdiction should be implemented. More specifically the parties should address themselves to the method which should be used in computing gas royalty payments and what additional filing requirements, if any, should be imposed and upon whom." (Footnote omitted)

A number of interventions were filed with the producers and distributors generally supporting a finding of jurisdiction and royalty owners and their associations generally opposing jurisdiction.

EXAMINER'S DECISION

Following a hearing, Examiner Alvin A. Kurtz held that the royalty owners are natural gas companies for purposes of the Act and payments to them are subject to the jurisdiction of the Commission. He further held that filings would be necessary by a royalty owner only when he asserted a higher price for his fractional share of the gas than that which the producer or lessee was authorized to collect. In reaching his conclusion, Examiner Kurtz held that removal of the royalty percentage of the gas from effective Commission regulation whenever the royalty contract is interpreted to base the landowners share of the revenues on a percentage of the unregulated field or market price would create a gap in that regulation which was not intended under the Act or the various court decisions. In this respect, he relied especially upon *Phillips v. Wisconsin*, 347 U.S. 672 (1954), *United Gas Improvement Co. v. Continental Oil Co.*, 381 U.S. 392 (1965) and *California v. Lo Vaca Co.*, 379 U.S. 366 (1965).

He also noted that in 1957 and 1959 in two unreported cases,[1] the Commission, at the request of royalty owners, had issued certificates to them; also noting that Commissioner Digby protested these as making a landmark policy decision without sufficient consideration. He rejected the royalty owners' reliance on *F.P.C. v. Panhandle Eastern Pipeline Co.*, 337 U.S. 498 (1949) where it was held that the transfer of undeveloped leases was not subject to Commission jurisdiction. He noted that that case involved the transfer of leases where the gas was to be sold in intrastate commerce, where in these cases the gas is being sold interstate. He noted that by the terms of the lease, the royalty owner had a continuing interest in production and the flow of gas into interstate commerce. Noting that our basis for fixing area rates was based on cost computations including royalties, he found that there could be a substantial effect upon consumers if excessive royalties were collected, and thus concluded that it was necessary to assert jurisdiction to protect consumer interests as intended by the Act.

The Examiner, likening a royalty interest holder to that of any other interest owner, including nonsignatory working interests, noted that in *Sun Oil v. F.P.C.*, 256 F.2d 233, cert. denied, 358 U.S. 872 (1958), it was held that regulations providing that nonsignatory parties, or those selling on a percentage basis, need not be permitted to file certificate applications or rate schedules in the absence of a waiver for good cause. On this basis, he further concluded that filings by royalty owners should be avoided as far as feasible and need only be made where the royalty owner intended to justify a higher price for a fractional share of the gas over that of the

1. Docket No. G-11462, June 3, 1957 and Docket No. G-10001, March 23, 1959.

lessee. He further concluded that any regulations necessary to this should be the subject of a general rulemaking applicable to all royalty owners.

EXCEPTIONS

Exceptions to the examiner's decision were filed by the royalty owners named in complaints by the producers, by Denman, by the Old Ocean Royalty Owners Association and by the Land and Royalty Owners of Louisiana. Exceptions were also filed by the staff and a number of the producers.

In general, the producers' exceptions were directed only at the examiners recommended procedures which would allow a royalty owner to file for a higher price for his percentage of the gas than the producers were getting for their percentages in circumstances where the producers' contracts rather than just and reasonable (or in-line) ceilings set by the Commission were the limiting factor. The producers in general believe that the royalty owner should be allowed no more for his percentage of the gas than the finally effective rate which the producer has on file. Humble, Marathon and Texaco excepted on the ground that the examiner made insufficient findings of fact and law and, therefore, they could not comment on the decision since he did not state his basis adequately.

Shell Oil Co. excepted to the examiner's finding that royalty owners were natural gas companies, contending that regulation of royalty payments was necessary only to the extent that payments based upon a market price higher than the regulated price could have an effect on the regulated price of gas moving in interstate commerce.[2] Shell concluded that the burden on interstate

2. This was also the position taken by Tenneco Co. before the presiding examiner.

commerce which might result was sufficient basis for the Commission's exercise of jurisdiction to hold all royalty owners to the contract specified percentage of Commission-approved prices and that it was unnecessary to this end to find that the royalty owners were natural gas companies making sales of gas for resale in interstate commerce. In reaching this conclusion, Shell relied to a large extent on *Northern Natural Gas Co. v. State Corporation Commission of Kansas,* 372 U.S. 84 (1963).

Staff exceptions were limited to the examiner's implementation procedure. Staff took the position that no filings by royalty owners should be required, but that a royalty owner, if contractually entitled thereto, should be allowed to obtain a Commission-fixed area rate, whether or not the producer was receiving that high a rate. This situation would arise primarily where the producer had settled at a rate below the area rate ultimately determined. In addition, staff would provide that the royalty owner could, if contractually entitled, collect this rate all the way back to 1954.

The various royalty owners and associations object both to the finding of judisdiction and the limited implementation of jurisdiction if upheld. In general, the royalty owners argue that a mineral lease is a simple transaction in real estate and not in any way a sale in interstate commerce by the landowner. They argue that the royalty payment is only a small part of the lease which is in fact only a rental of the land for various considerations. They argue that the lease creates only a contractual relation of lessor and lessee between the royalty owner and the producer and that such contracts have always been governed by state law.

The royalty owners further note that they were in no way a party to the sale of the gas by the lessor to a

pipeline purchaser, nor have they ever been included in settlement proceedings before the Commission. They further state that there should be no effect on consumers from the payment of royalties since this is done by the producer within the area rate and is not passed on to the pipeline purchaser. They suggest that worrying about the royalty payment as an included cost in area rates is no different than worrying about the cost of steel pipe, bonus payments, delay rentals, labor costs, etc. They contend that the FPC in asserting jurisdiction would not be regulating the price of gas but rather the cost of production.

In reply to these arguments the staff, producers, distributors, and the State of California point out that the mineral lease requires that the producer sell the gas as best he can and that in fact the royalty-payment provision of the lease is not operative until the gas is actually sold. They argue that what the royalty owner gave in a mineral lease was a sale of gas, or other minerals, in place for a certain consideration and that the lease was a necessary part of the whole sale transaction which results in the flow of gas through interstate commerce. They further argue that what the royalty owner does is retain a fractional interest in all production pointing out that he gets a depletion allowance just like any other interest owner. In this connection, the producers also argue that just like any other interest owner the royalty interest should be covered by the filing of the operator of the lease and there is no need for any filings by royalty owners.

CONCLUSION

Based on the evidence in this proceeding, the parties' briefs, the examiner's decision, the exceptions and replies

and the oral argument before us, we conclude that the Commission does have jurisdiction over the royalty owners' interest in natural gas sold for resale in interstate commerce and that such jurisdiction can be implemented without undue additional administrative burdens upon the parties or this Commission.

DISCUSSION

The basic fact here is the effective retention by the royalty holders of a percentage interest in the gas sold in interstate commerce. While that portion of the royalty contract on which the royalty owners focus, which results in payments prior to the production or discovery of natural gas or payments unconnected with the production of gas, may well be nonjurisdictional under the decision in *Panhandle Eastern Pipeline Co. v. Public Service Comm.*, 337 U.S. 498 (1948), the remaining portion of the arrangement, which results in payment to the royalty holder based on the production of natural gas for sale in interstate commerce, seems to us plainly to be jurisdictional. This distinction between persons providing goods or services for a production operation for a percentage of the receipts of subsequent gas sales and those receiving, instead, fixed fees is not novel. Thus if a producer needs $30,000 to pay expenses for his exploratory and development activities and secures $10,000 each from A, B and C, with A taking a note for repayment of the loan with interest, B taking a 10 percent interest in the gas sale proceeds and C taking a note for $5,000 and a 5 percent interest in gas proceeds for the other $5,000, it is clear that B will technically be a natural gas company (though probably a nonsignatory, nonoperator party not eligible under the Commission's Rules to file a separate rate schedule or secure a separate cer-

tificat) and C will be also, though not with respect to the $5,000 on which it merely took a note.

In viewing the overall problem here presented it would be senseless to attempt to determine what is a natural gas company and what is a sale on the basis of Hornbook definitions or local decisions not applicable to the Natural Gas Act. The question of whether royalty payments are subject to our jurisdiction must be examined with the terms of the Natural Gas Act in mind together with the intent of Congress, in the passage of that Act, to assure an adequate supply at the lowest reasonable rates. For purposes of the Act, a "natural gas company" is a person engaged in "the sale in interstate commerce of [natural] gas for resale" but whether his operations would be classified as a "sale" under private law is not determinative, *UGI v. Continental Oil Co.*, 381 U.S. 392. The issue here is whether a person receiving payment for a percentage of each or any Mcf of natural gas sold for resale in interstate commerce is in fact engaged in a sale of such gas for purposes of the Natural Gas Act. We conclude that if he has contracted to retain an economic interest in interstate sales, he has joined the other interest owners in such sales and he has become a seller of natural gas and therefore a natural gas company.

While the royalty owners in this proceeding have emphasized the various provisions contained in the mineral leases covering such things as bonus payments, delay rentals, and shut-in royalties, the only provisions in any of the leases which are relevant to this proceeding are those which provide for payments after gas is actually being produced and marketed. There are various provisions in these leases providing for such royalty payments based on "proceeds," "market value," "market price,"

"wellhead value," etc. These provisions may provide for the payment of a percentage of one of the above or provide that one of the above will be paid for a fraction of the gas. Regardless of which of the provisions is in the lease the payment is based on the production and sale of the gas. Thus it is clear that the royalty payments represent an interest in the sale of the gas and represent payment to the royalty owner for this interest in the sale.

Some of the parties who agree that a sale of gas by a royalty owner does take place have suggested that the sale is an in-place sale of all the gas to the producer, the compensation therefor being a percentage of the proceeds of any resale. The question of whether the sale is in-place to the producer who then sells the gas or the direct sale of a fractional interest to an interstate pipeline would seem to be irrelevant for jurisdictional purposes in light of the decision of the Supreme Court in *United Gas Improvement Co. v. Continental Oil Co.*, 381 U.S. 392 (1965). See also *Deep South Oil Co. v. FPC*, 247 F.2d 882 (CA5, 1955). In either event it is subject to our jurisdiction.

The same applies to the argument made by Shell Oil Co. and Tenneco Oil Co. that jurisdiction should rest on the burden created on interstate commerce by allowing royalty payments in excess of producers' rates. If in fact there were no sale for resale involved, then jurisdiction might well be found under the holdings in the cases of *Northern Natural Gas Co. v. State Corporation Commission of Kansas*, 372 U.S. 84 (1963) and *U. S. v. Southwestern Cable Co.*, 392 U.S. 157 (1968). However, since we find that an actual sale for resale by an interest owner does take place under the royalty provisions of the mineral

leases the argument of Shell and Tenneco constitute an additional, but not the basic, reason for asserting jurisdiction.

The argument against now asserting jurisdiction over royalty interests based on our failure to assert it since 1954, aside from its basic lack of merit (see *Phillips Petroleum Co. v. Wisconsin,* 347 U.S. 672) also lacks a partial foundation. As indicated, *supra,* in the only two instances where the matter has previously been before us we asserted jurisdiction. While we do not suggest that these brief orders are decisive of the legal question, we point out that prior to the recent decisions interpreting market value provisions of royalty contracts to afford royalty owners a fixed percentage of a higher unregulated price, there was no more reason to assert special jurisdiction over royalty interest holders than over the producers making percentage sales to other producers or plants. Our rules for producer filings since 1954 have provided that the filing by the producer shall cover the interests of all nonsignatory parties or those selling on a percentage basis. Our rules further provide that nonsignatory co-owners or percentage sellers may not file on their own behalf in the absence of a waiver of our rules as necessary to protect their separate interests. This method of regulation was specifically upheld in *Sun Oil Co. v. F.P.C.,* 256 F.2d 233, *cert. denied,* 358 U.S. 872 (1958).

The jurisdictional royalty interest has in effect been covered by the producer filing since 1954 and we see no reason why it should not continue to be covered by the producer filing. As the evidence in this case indicates, until these proceedings were instigated, the general practice was for the producer to settle with the royalty in-

terest on the basis of his filed rate. We assume that this will continue to be the practice in almost all situations and, therefore, no provision beyond our existing rules ordinarily will be necessary to cover regulation of royalty interests.

We do, however, recognize that for the first time these proceedings represent an argument by an interest owner that his reimbursement from the producer is not in accord with his contract. While we find that the royalty owner has authorized the producer to sell his interest, we do not believe the royalty owner must be held to the producer's filed rate if his contract with the producer calls for royalties based upon a different rate which the producer could have secured under Commission regulation had he contracted for it. As is any interest owner, the royalty owner is free to write his own contract subject only to the limitations of the Natural Gas Act. Thus the royalty owner is limited in the price upon which his royalty interest is to be based only by the limits of the Natural Gas Act. Where he has contracted for the market price or value it would appear that he has contracted for a payment equal to the maximum rate for such gas which could have been received as fixed under the law by this Commission. Since he is selling gas in interstate commerce, his rates are subject to Commission approval and he cannot under the Act receive a price in excess of the just and reasonable rate, whatever the provisions of his contract. Thus a producer who has agreed to pay the royalty interest owner something more than he himself receives for the gas could be required to pay the just and reasonable rate as fixed by the Commission. Where no just and reasonable rate has been fixed and the producer has agreed to pay the royalty interest owner more than he himself re-

ceives for the gas, we believe that the parties will be required to settle on the basis of the effective rate subject to adjustment when the just and reasonable rate is determined. With this guidance we see no reason why the producer and royalty owner cannot settle between them without additional filings by the royalty interest owner or the producer.

Inasmuch as we have asserted jurisdiction over producer rates only since June 7, 1954, the principles enunciated herein will apply only to gas which has flowed since that date. For gas which flowed prior to June 7, 1954, the parties will be left to their contractual remedies, to the extent otherwise viable. These disputes are, of course, matters which are for resolution by a court of competent jurisdiction.

The Commission further finds:

(1) The royalty payment provisions of oil and gas leases constitute a sale for resale of natural gas in interstate commerce subject to regulation under the Natural Gas Act and the royalty owners are natural gas companies for purposes of the Act.

(2) The interests of the royalty owners are covered by the filings of the producer-operators and no additional filings with this Commission are required.

The Commission orders:

(A) Based on the above opinion and findings, it is hereby declared that the royalty provisions of oil and gas leases constitute sales of natural gas for resale in interstate commerce subject to all of the provisions of the Natural Gas Act.

(B) For regulatory purposes such sales are covered by the filings of the producer-operators and payment by the producers to the royalty owners should be made as provided by the contractual provisions of each lease, except that in no event should the payment exceed the just and reasonable rates as fixed by the Commission under the Act.

By the Commission.

Commissioner Carver dissenting in part and concurring in part filed a separate statement appended hereto. Commissioner O'Connor dissenting in part and concurring in part filed a separate statement appended hereto.

(SEAL)

KENNETH F. PLUMB
Acting Secretary.

CARVER, Commissioner, *dissenting* in part and *concurring* in part:

This matter comes before this Commission in the form of petitions for declaratory orders and complaints in opposition thereto, all designed to secure a determination as to the jurisdiction of the Commission to regulate royalty payments under oil and gas leases. Many of those leases pre-date the enactment of the Natural Gas Act; at least one of the leases involved in *Denman* (Docket No. RI67-113) has been in effect since 1926.

We may (indeed we must, if the true significance of the proceeding is to be recognized) take official notice of the fact that the real moving force in the matter is a judicial decision in a proceeding to which the Commission was not a party, as described in the majority opinion, *J.M. Huber Corp. v. William Harvey Denman, et al.* (1966) 367 F.2d 104. Our reply to questions raised by the United States Court of Appeals for the Fifth Circuit can be indirect at best, however, since its directive was to the parties before it; there has been no direct referral or certification of any questions to this Commission by the Court. Our decision must, therefore, be responsive to the issues as they have been presented to us by the parties.

In this connection, I feel compelled to express misgivings as to whether the procedure involved here represents a proper and acceptable application of the doctrine of primary jurisdiction. The careful, learned and extensive opinion of the Fifth Circuit goes to some length in demonstrating that "there is really nothing startling about submitting to an agency for initial decision the question of its own jurisdiction." With all due respect, the prece-

dents cited seem not to support that conclusion as applied here.

In none of the cases referred to by the Court was a regulatory or administrative agency called upon to exercise the full, free and initial scope of its discretion in defining its own jurisdiction. The cases involved fall into two categories: (1) those where the Court itself found, as a matter of law, that the matter in issue was clearly within agency jurisdiction and, as a result, was not ready for judicial determination, *Southwestern Sugar and Molasses Co. v. River Terminals Corp.* (1959) 360 U.S. 411, *U.S. v. Western Pacific R.R.* (1956), 352 U.S. 59, *Far East Conference v. U.S.* (1952), *Carter v. A.T.T.* (1966) 365 F.2d 486; and (2) those in which the agency had already asserted its jurisdiction and taken steps to implement it, but was unable to take final action because of an appeal from or collateral attack upon its jurisdictional finding. *Marine Engineers Beneficial Association v. Interlake Steamship Co.* (1962) 370 U.S. 173, *Myers v. Bethlehem Shipbuilding Corp.* (1938) 303 U.S. 41, *Arkansas Power and Light Co. v. F.P.C.* (1945) 60 Fed. Supp. 907 (ultimately affirmed, *per curiam* (1947) 330 U.S. 802).

As the Court has recognized, however, the procedure it has adopted represents a novel *application* of the primary jurisdiction doctrine. This is by no means to say that it is an erroneous or improper one; indeed the philosophy of judicial-administrative comity evidenced therein is constructive and deserving of increased usage. My concern arises from the narrow terms of reference within which the Commission is asked to make its decision. Since this point involves questions of the independence

of the regulatory function, I believe the matter should be exposed to discussion, even though there may be no clear basis for resolution in this proceeding.

In the District Court phase of the *Denman* case, four questions were stipulated for decision, three involving substantive questions of lease or contract interpretation and the other having to do with FPC jurisdiction. All were decided by the District Court. The three substantive issues were affirmed by the District Court, to the effect that royalty provisions expressed in "market price" terms meant that prices in excess of regulated rates fixed by this Commission should be used in royalty computations. In effect, therefore, we are on notice that unless we subject royalty rates to our control under the Natural Gas Act and, through interpretation of that Act, restrict royalty rates to a percentage of the regulated price, we must anticipate pressures to increase the rates authorized for interstate sales of natural gas. By this device, a strong incentive for a jurisdictional finding has been established by judicial predetermination.[1]

The Circuit Court then proceeded to its own analysis as to how the Commission might implement its jurisdic-

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1. This observation is made in full recognition of the dilemma which confronted the Fifth Circuit. In Southwestern Sugar and Molasses Co. v. River Terminals Corp., *supra,* that Court was partially reversed for failure to resolve substantive questions of law before remanding the case for ICC determination. On the other hand, a long line of cases has established the rule that "courts ordinarily should not interfere with an agency until it has completed its action, or else has clearly exceeded its jurisdiction," reiterated as recently as the last term in McKart v. U. S. (1969) _____U.S._____, 89 S.Ct. 1657. The sharp factual differences between this case and Southwestern Sugar are important; in the latter, the substantive questions of law were determinative of the case and in fact, eliminated any need for ICC consideration, which was the real reason for remand.

tion if it were found to exist. In so doing, the Court tended to minimize excessive administrative requirements, thereby adding to the prejudice in favor of a jurisdictional finding. Through that process, moreover, the Court has exerted heavy influence on decisions that are allocated to the regulatory discretion of this Commission. In the face of its advice we are hardly free agents as to the best ways to implement jurisdiction, if found.

Finally, although the Court refrained from addressing any directive to this agency, it specified in precise terms what jurisdictional issues the parties should present for our decision. In the context of the case then pending before the Court, some or several of those issues were and are not ripe for decision and the proper parties may not have been before this Commission to compile a proper record for decision. Despite the extent and specificity of the judicial pronouncement, therefore, our decision must be limited to the matters presented to us.

Notwithstanding the straight-jacket implications of the terms under which the matter reaches us, the fact is that numerous parties have petitioned us for a jurisdictional determination. While I feel that the original litigants should have sought further judicial recourse from the Circuit Court's decision for the reasons outlined above, I agree that we have no alternative but to decide the issues to the extent that they are now before us by legitimate process.

The question we are called upon to decide is twofold: (1) whether, as a general proposition and under the relationships normally and usually created by standard oil and gas leases, this Commission has jurisdiction to control the amounts received by royalty interest holders

for gas production, and (2) whether the specific leases under scrutiny in these proceedings conform to the general concept such as to bring them under the conclusion reached in (1) above. The majority reaches an affirmative conclusion on the initial issue and on such a broad basis that the same result automatically follows as to the subsidiary question.

I reach an opposite result on the main issue and therefore must express a general dissent. On the other hand, at least as to one of the leases in one of the cases before us (the R-Lease in Docket No. RI67-113) there is a factual abberation which requires a different conclusion. As to that particular transaction, I concur in the result reached by the majority, but for wholly different reasons as set forth below.

The Presiding Examiner's Initial Decision identifies the central issue with accuracy and precision: ". . . the issue as to the Commission's jurisdiction must be determined under the provisions of the Natural Gas Act." (Mimeo. at p. 12). In the whole complex history of jurisdictional litigation, the one visible point of reference is that our authority and our responsibilities are statutory in origin; for us, jurisdiction is an inescapable function of statutory construction.

My basic disagreement with the Examiner's decision and the sustaining view of the majority opinion is that the test so clearly defined in the initial decision has not been met. With only the most general reference to statutory criteria and in reliance on precedents that have no direct bearing on the present issues, all royalty owners under conventional leasing agreements are declared to be "natural gas companies" engaged in the "sale in inter-

state commerce of natural gas for resale," whether they happen to be experienced exploration investors or plain dirt farmers willing to facilitate a wildcat venture. For me, such a bootstrap conclusion taxes credulity to the breaking point.

The majority opinion goes beyond the limits of statutory definition in seeking a jurisdictional peg. At least on a "make weight" basis, it adopts the intriguing theory advanced by certain intervenors (principally Shell and Tenneco) to the effect that the Commission has an ancillary duty, or is faced with a compelling necessity in aid of its comprehensive function, to abate a burden on interstate commerce. In my judgment this view is untenable and must be resisted, even though it is not central to the present opinion.

The Concept of a "Sale" of Natural Gas

In the search for a statutory mooring that will sustain an exercise of jurisdiction, the majority opinion relies on three basic premises: (1) that there has been a "sale in interstate commerce of natural gas for resale" to which royalty owners have been parties in sufficient degree to make them subject to the Act, (2) that this "has been so all along" under the terms of our regulations and prior actions on certificate applications, and (3) that failure to so hold would conflict with judicial expressions of general philosophy that the Natural Gas Act has an overriding purpose to provide a comprehensive scheme of regulation which can tolerate no gaps or evasions.

Quite obviously, if the first two enumerated elements, or either of them, is satisfied with certainty, there is no

need to construct a complex fabric of generalizations to reach beyond the express terms of the statute. This lack of confidence in the specific premises is so fully justified that I cannot accept the final basis of decision as supplying the deficiencies of the others.

In order to support a finding that royalty owners have participated in a sale of natural gas, it is essential that some specific operative act, some definite transaction, be identified as having the legally accepted characteristics of a "sale." Except for a brief colloquy in oral argument before the Commission (Tr., p. 935), that kind of analysis does not appear in the record of this proceeding. Does the sale occur as a necessary incident of the original lease transaction? Or is it to be inferred from the separate, usually subsequent, contract by which the lessee-producer commits his production to an interstate pipeline purchaser?

We don't know the majority's theory in this respect, because the issue, and indeed the whole matter of how a sale occurs, is evaded by a forensic *tour de force*. The fact of a sale is declared, rather than demonstrated by any acceptable rationale. And we are told that technical concepts of law have no bearing since this Commission is not bound "by Hornbook definitions or local decisions not applicable to the Natural Gas Act." There is little doubt that this is an accepted benchmark in rule case law, both as a general proposition in the construction of Federal statutes, *Prudence Realization Corp. v. Geist* (1942) 316 U.S. 82, and as specifically applied to the Natural Gas Act, at least in the context of *Rayne Field, United Gas Improvement Co. v. Continental Oil Co.* (1965) 381 U.S. 392.

But we are not at liberty to enlarge that principle into an unrestricted license to snatch our own definitions out of the cosmos, hand-tailored to fit the case, any more than problems of consideration can be swept away by denigrating reference to established legal concepts. The precise task at hand is to give meaning and effect to the "sale for resale" criterion of jurisdiction and to measure the concept of a mineral lease against that standard. Absent some clear indication that Congress meant to abandon and deny accepted principles of property and contract law, they should be used as interpretative guideposts and aids to construction.

Notwithstanding the limited effect historically given to the Rule of Decision Act, now revised and codified at 28 U.S.C. 1652, and the systematic erosion that has occurred into the *Erie v. Tompkins* doctrine,[2] there is still a strong policy predilection toward reliance on State law "to give meaning and content to federal statutes" especially in matters relating to the acquisition, transmission and transfer of property. *Davies Warehouse Co. v. Bowles* (1943) 321 U.S. 144, 145.

Unfortunately, even reference to State court decisions may not be particularly helpful in a positive way in this instance. As the Fifth Cricuit has pointed out, even the standard treatises on oil and gas law have extreme difficulty in reconciling the great variety of holdings on the essential nature of mineral leases and the interests created thereunder. Thus a gas lease may be regarded as conveying an interest in real property, or granting a *profit*

2. See Friendly, "In Praise of *Erie* and of the New Federal Common Law," (1964) 39 N.Y.U. Law Review 383; unsigned Note, "The Federal Common Law (1969) 82 Harvard L. R. 1512.

aprendre, or a corporeal or incorporeal hereditament, and the legal and economic interests thus created may be equally lacking in uniformity—all depending on local law.

What seems most important for our purposes here is what the State decisions have *not* held. Viewed in this perspective, one basic point of unanimity survives: *in no State has it been found that a primary lease constitutes a sale of gas as a commodity separate and apart from its association with the realty*. Thus, the fact we may not be *required* to apply local law in each instance provides little justification for adoption of a rule that would be contrary to the prevailing law in *all* jurisdictions, however the local rules may vary.

If it is intended that the case rest on the alternative theory that the "sale" occurs at the point of commitment to the interstate market, that view founders on an elemental point of contract law. To be binding on the royalty owner, he must be construed to be a party to the producer-pipeline purchaser agreement. But this requires a showing of privity and a party is not considered privy to a sales transaction unless he has had some voice, some indication of positive acquiescence in its terms. Effective control, at least in proportion to legal interest, over the offer or the acceptance is essential to participation in the contract.

With the exception of one of the contract documents involved in Docket No. RI67-113, which is discussed under a separate heading below, there is nothing in this record to demonstrate, or even suggest, that royalty owners participate in any way in producer decisions on product marketing. That is solely a function of the working interest, as that term is fully and accurately set forth

in the Examiner's opinion (and see below). Once a lease has been executed, absent a specific and atypical provision to the contrary therein, the royalty interest is a wholly passive factor in the subsequent enterprise.

To say, as the majority opinion does, that "he [royalty owner] is selling gas in interstate commerce" is simply not supported by the record or by the relationships that have developed in this important industry. If he had any effective voice in marketing decisions, the royalty owner would always opt for the highest price (and therefore the highest royalty income) regardless of the producer-lessee's commitments to the interstate regulated market. That he cannot control this decision is ample evidence that he is not a party to the sales transaction.

The majority opinion places principal reliance for finding a sale on *Rayne Field (UGI v. Continental Oil Co., supra)* and the cases which have followed it. *Pan American Oil Co. v. F.P.C.* (1964) 339 F.2d 694 (Bastian Bay); *Continental Oil Co. v. F.P.C.* (1966) 370 F.2d 57, *cert. den.* 388 U.S. 910 (Ship Shoal area). It is now familiar that these cases establish jurisdiction over the *transfer of leasehold interests in proven and developed fields for eventual resale in interstate commerce.*

The three elements emphasized above make *Rayne Field* inapplicable and irrelevant here; none of the essentials for a jurisdictional sale are present at any time when the royalty owner exercises any effective control. First and foremost, the interest being conveyed is clearly distinguishable. There the working interest of a lessee-producer, an established "natural gas company" with full discretion and control over marketing, was being transferred to an interstate pipeline company; here the subject

matter is the royalty interest of a party not otherwise involved in the gas sale transaction. Since the royalty interest, in legal effect, has been "reserved," lessee-producer does not have it within his power of disposal. Second, known and developed reserves of gas were conveyed; at the leasing stage, no gas is being transferred, but only the right to explore and to develop and market if exploration is successful. Finally, at the time of the lease, the ultimate destination of potential gas supplies is unknown and the royalty owner can have no knowledge of or control over that decision.

Bastian Bay and *Ship Shoal* serve to clarify and amplify *Rayne Field,* rather than expand upon its substantive holding. In general, they represent a testing of the "development' criterion; but *Ship Shoal* does add a useful dimension by restating and emphasizing the essential character of the phenomenon involved: the significant and determinative economic fact is whether the sale of leases accomplished the transfer of large amounts of natural gas to an interstate pipeline for resale in other States. In short, the economic effect must be the same as a conventional sale of gas. It is difficult to conceive of any rationale by which retention and exercise of a royalty interest can be regarded as tantamount to a conventioal sale.

In point of time and the legal and economic interests created, primary lease execution is clearly antecedent to any facet of "production and gathering." The lease constitutes the very essence of the relationship between landowner and lessee-producer. If the language in *F.P.C. v. Panhandle Eastern Pipeline Co.* (1949) 337 U.S. 498, 505, holding "leases an essential part of production" is not controlling here, it is difficult to conceive of a case

where it would be. An undeveloped leasehold interest is clearly more akin to *Rayne Field* situations than is a passive royalty interest. It has not been suggested that this aspect of *Panhandle* has been reversed or superseded and there seems to be no reason to anticipate such a result here.

The Effect of Prior Regulations and Adjudications

The majority further maintains that the entire matter at issue is settled by the fact that royalty interests have already been subjected to jurisdiction through inclusion as non-signatory interests under regulations in effect since 1954 (presumably sec. 154.91(d), *Regulations Under the Natural Gas Act*. This assumption is in conflict with the same principle of privity that was encountered in connection with the sale theory outlined above.

Any rational application of the regulatory provision involved must require that the signatory and non-signatory interests be substantially identical in dimension and effect. In essence they must be so closely allied as to make the signatory party an agent for the others. But the royalty interest in a conventional oil and gas lease is not a party to the ultimate marketing contract which is in the exclusive domain of the leasehold or working interest.

Similarly, "those selling on a percentage basis" can be construed, reasonably, to include only those holding a percentage portion of the working or leasehold interest. The royalty holder is "selling" nothing; he has granted a development and marketing right out of his total realty interest, with the rental value to be measured by the value of production.

Although it is conceded that brief and unpublished orders issuing certificates to royalty owners in earlier cases are not decisive of the legal issues here, the majority opinion accepts them as evidence of prior determinations of jurisdiction. Again, the parallels are not apt. In *Elk River* (Docket No. G-11462, June 3, 1957) and *Northern Natural* (Docket No. G-10001, March 23, 1959), the interest retained by the royalty owners was a percentage or fractional part *of the gas produced from the leased properties* which was subsequently assigned to and sold by the lessee-producer for the account of the lessor. An agency relationship is thus clearly established, reasonably within jurisdictional reach. In *Northern Natural,* moreover, there was a transfer of working interest bringing the transaction in line with *Rayne Field* and jurisdictional on that ground. Neither case involved the jurisdictional status of a royalty interest expressed in terms of percentage or fraction of the "market price."

The royalty owners acquire no interest in and never become parties to the sale of gas as such. Their interest is a purely monetary one, measured by the volumes of gas produced and its value at the time of production. To ignore the essential difference between royalty and working interests, or to lump them together by indiscriminate generalization, is to beg the very question we are called upon to decide.

The prior actions of this Commission offer no more guiding precedent than do judicial considerations which are not addressed to the royalty interest question.

The Special Circumstances of Denman's R-Lease

While I find it impossible to hold a royalty owner within our jurisdiction under the normal and usual form of a conventional oil and gas lease, not every lease arrangement will fall in this category. This variation does not seem to have been emphasized in any part of our proceeding. But the Fifth Circuit has pointed out quite clearly (*J.M. Huber Corp. v. Denman, supra* at p. 108) that the so-called R-Lease in Docket No. RI67-113 differs from the normal, both in specific content and in its background.

That lease has been introduced as the first item under Exhibit No. 16 in our record. Section IX thereof recites the fact that the gas to be produced from the lease had already been committed to a specific and antecedent marketing contract. We may take official notice of a finding by the Fifth Circuit which explains the origin of this unusual provision. In the initial lease negotiations, the lessor (here represented by Denman) demanded as a condition precedent that the applicant lessee produce a marketing contract as evidence of capability to sell any gas which might be found. The potential purchaser was Northern Fuel Supply, an established interstate transporter, now known as Northern Natural Gas Company.

Through the business acumen evidenced in this insistence on a definite market for a product which was then (1936) in surplus supply, the lessor clearly identified his interests with those of the lessee-producer. The privity found lacking in the usual and normal leasing arrangement is supplied under these particular facts. Moreover, the recitation in Section IX of the lease constitutes an affirmative ratification of the sale contract.

The sale to an interstate carrier was consummated at the lessor's insistence and was accepted and ratified by him. He cast his lot and chose to take his chances with the lessee-producer; he must also accept the consequences of that choice. True, the royalty owner could not have known in 1936 that his lease agreement would be subjected to price regulation over thirty years later—but neither could the lessee foresee this development. Since they joined in a common and mutually acceptable venture, the burdens should fall in equal proportion.

To this extent, I would regard the *Denman* interest under the R-Lease as being bound by Huber's earlier filings. No similar fact situation has been brought to our attention in any of the other cases, but the parties would be free to institute new proceedings where special facts would take a particular lease out of the general rule expressed above.

Abatement of a Burden on Commerce

Some of the parties urging regulation of royalty rate payments would not go so far as to find such rates subject to the Commission's jurisdiction. Rather, we are urged to act on the royalty rate question, isolated from any other aspects of jurisdiction, because the rates allowed under the trend of judicial interpretations will constitute a burden on interstate commerce.

In its broadest context, the power to regulate (and therefore to protect) commerce is an express grant of constitutional authority to the Federal government. When the Federal sovereignty in this area has been implemented, State acts which are in conflict must give way. But

the constitutional provision is not a universal grant, available under any and all conditions. It is an express and specific allocation of legislative power, and it is Congress that regulates commerce among the States and with foreign nations.

This Commission does not derive its authority from the constitutional grant itself nor does it apply the Constitution in its original terms. We must, therefore, return to the premise on which we started—that our authority, whether it be regarded in jurisdictional or substantive terms, must be found in statute. If the Natural Gas Act may be interpreted to bring royalty rates within our ambit, then royalty owners are subject to jurisdiction *per se* and we need not indulge in esoteric argument about extra jurisdictional powers over interstate commerce.

Clearly Congress *could* have given us this function; equally clearly, it has not done so. The mere fact that the constitutional power exists does not mean that it has been exercised, and it has been held that the Natural Gas Act did not necessarily occupy completely the total area open to regulation. *F.P.C. v. Panhandle Eastern Pipeline Co., supra,* 502. That principle has not been superseded and it is wholly applicable to the "burden on commerce" argument here.

The majority cites *Northern Natural Gas Co. v. State Corporation Commission* (1963) 372 U.S. 84, and *U.S. v. Southwestern Cable Co.* (1968) 392 U.S. 157, as supporting this theory. Neither seems pertinent since there was not involved any question of authority to act without statutory sanction. In each case it was held that the subject matter was reasonably within the scope of the

Federal regulatory statute involved, which is not the case here under my view of the matter.

In conclusion, it is significant to note that we are dealing with past history, albeit there is a current impact. We are asked to assert our jurisdiction on a retrospective basis only. For it can hardly be said that lessee-producers need our protection for future lease transactions. They are clearly on notice that "market price" clauses may be construed in a manner adverse to their interests. One may have ultimate confidence in their capacity to protect their interests in the future by more artful lease draftsmanship.

/s/ John A. Carver, Jr.
John A. Carver, Jr.,
Commissioner.

O'CONNOR, Commissioner, *dissenting* in part and *concurring* in part:

I agree with Commissioner Carver's conclusions and I would further add:

The majority bases its decision upon a finding of authority in the Natural Gas Act and states "We conclude that if he has contracted to retain an economic interest in interstate sales, he has joined the other interest owners in such sales and he has become a seller of natural gas and, therefore, a natural gas company." Thus, in one broad stroke the majority has wiped out whatever distinctions there may have been between working interests and royalty interests. Apart from the distinctions which Commissioner Carver pointed out, other distinctions exist which further indicate to me that the execution of a lease cannot be considered a sale of gas in interstate commerce. The fact that a royalty interest derives its share free of the costs of operating the lease,[1] or the fact that every jurisdiction where the point has arisen in litigation[2] has defined a royalty as compensation to the owner of the land for the privilege of exploring, developing and producing oil and gas, does not interest the majority. Nor does it cause them to pause and consider whether these distinctions might not mean that the royalty interests in-

1. *Shinn v. Buxton*, CCA Okla., 154 F.2d 629 (1946), *Duvall v. Stone*, 54 N.M. 27, 213 P.2d 212 (1949).

2. *Indiana Natural Gas & Oil Co. v. Stewart*, 45 Ind. App. 554, 90 N.E. 384 (1910).
Hinerman v. Baldwin, 67 Mont. 417, 215 P. 1103 (1923).
Vincent v. Bullock, 192 La. 1, 187 So. 35, 39 (1939).
State National Bank of Corpus Christi v. Morgan, 135 Tex. 509, 123 S.W.2d 1036, aff. Com. App. 143 S.W.2d 757 (1940).
Hickey v. Dirks, 156 Kan. 326, 133 P.2d 107, 109, 110 (1943).
Hinkle v. Gauntt, 201 Okl. 432, 206 P.2d 1001 (1949).
Longino v. Machen, 217 Ark. 641, 232 S.W.2d 826 (1950).

volved are different from the other interests in the gas and perhaps should be treated differently. These two distinctions indicate to me that the lease is characterized by the physical acts of production that are expressly exempt from regulation by the Natural Gas Act and, therefore, beyond this Commission's control.

This entire record is based on leases which were signed before producer regulation was envisioned. I cannot believe that any producer today would enter a contract with a lessor wherein he granted more than he would receive for the gas when sold. Putting this another way, I cannot see anyone after today signing anything but a "proceeds" type lease.

As for the effect of the leases in question, the majority has stated that we have jurisdiction only over the producer rates since June 7, 1954, and as such we will only concern ourselves with the gas which flowed from Denman's wells from that date. Like Commissioner Carver, I have problems with the Denman "R" lease in that the lessor definitely tied his interests with the lessee's in demanding as a condition precedent that the lessee produce a marketing contract before the execution of the lease. This additional input by the lessor takes the "R" lease out of the usual "hunting license" category characteristic of lease agreements which have only a royalty agreement as opposed to the "R" lease in question with its attendant requirement of a marketing contract.

In *United Gas Improvement Co. v. Continental Oil Co.*, 381 U.S. 392 (1965), the Supreme Court makes clear that in determining whether a sale of gas has occurred, a functional approach rather than a formal approach must be used. In determining whether the lease sales then in

question could be determined to be "sales" of gas in interstate commerce, the Supreme Court said at page 401,

> "The sales of leases here involved were, in most respects, equivalent to conventional sales of natural gas which unquestionably would be subject to Commission jurisdiction under *Phillips Petroleum Co. v. Wisconsin,* 347 U.S. 672."

also,

> "But, it is perfectly clear that the sales of leases in Rayne Field, a proven and substantially developed field, accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other States. That is the significant and determinative economic fact."

This language clearly indicates to me that the relevant consideration for determining whether or not a sale of gas in interstate commerce has occurred should focus on all the functional incidents of the transaction rather than the legalistic and formal approach taken by the majority.[3]

In the usual royalty situation, the incidents of the transaction amount to a real estate transaction rather than a sale of gas. In the instance of the "R" lease, as well as

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3. See also, Rev. Rul. 69-355, I.R.B. 1969-26, 9.[Par. 6843] wherein the Internal Revenue Service in a ruling concerning Sec. 172 (1954 Code), *Net Operating Loss Deductions,* held that income received by the taxpayer for the taxable year from a royalty interest was not income derived from his trade or business for the purpose of computing the net operating loss under Sec. 172 of the Code. The Internal Revenue Service said, ". . . A royalty owner is not considered engaged in the trade or business of selling oil and gas where his 'sales' activity is limited to the signing of division orders." Also, ". . . A royalty interest owner is therefore not in the business of producing oil and gas since he has neither the right nor burden of developing and exploiting the property."

where a lessor takes his royalty in kind and negotiates his own sale, I feel the lessor has brought himself under our jurisdiction. Clearly, in these two instances, the lessor has undertaken to sell gas in interstate commerce for resale.

As for the gas which comes from the "B" and "M" leases, having decided that we have no control over any of the lease provisions, I do not hesitate to say that the royalty owners should get 100 percent of what they bargained for when they executed the leases. That is, they are entitled to receive a percentage of the "market value" as that term may be construed in a forum of competent jurisdiction. The authority of this Commission cannot and should not be inserted to short circuit that result.

Barring the two instances mentioned above, I believe our jurisdiction of the lessee-producers is sufficient in and of itself to guarantee "an adequate supply at the lowest reasonable rates." The point I want to make very clear is that in my opinion the consumer will not suffer from a higher price by not regulating the amount the producer will pay to the royalty owner. This price paid by the producer to the royalty owners falls in the same category as the wages paid to his drilling crews, and the price he pays for the pipe he sinks into the ground. Thus, any bargain struck between the producer and the royalty owner should be allowed to govern. To do otherwise would, as I stated in my separate statement to the United States Court of Appeals for the Fifth Circuit,[4] entitle the pro-

4. Separate statement of Commissioner Lawrence J. O'Connor, Jr., as Amicus Curiae at 31, *J. M. Huber Corp. v. William Harvey Denman & Jay Pumphrey*, Trustees for the Estate of S. B. Burnett, deceased *et al.* (C.C.A. 5th 1966).

ducer to get relief from the royalty owners even though that producer might have been improvident in entering into the lease on terms which, even though they were favorable, could still be reduced by the majority's decision here. Furthermore,

> ". . . Not only would he be insulated from what was an inducement to the lessor to enter into the contract; in addition, he, a pipeline, distributor, or other interested party, could allege before the Commission that the agreement was unjust and unreasonable, requiring a cost investigation into the royalty-owner's operations."[5]

It is for this reason and the others mentioned above that I see no need to expand the jurisdiction of this Commission.

/s/ Lawrence J. O'Connor, Jr.
Commissioner

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5. *Ibid.*

APPENDIX C

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Docket No. RI67-113
WILLIAM HARVEY DENMAN, Trustee, *et al.*
v.
J. M. HUBER CORPORATION

Docket No. RI67-114
MOBIL OIL CORPORATION
v.
CARL F. MATZEN, *et al.*

Docket No. RI67-310
WESTERN NATURAL GAS COMPANY
v.
ELMER HENNIGH, *et al.*

Docket No. RI67-400
PAN AMERICAN PETROLEUM CORPORATION
v.
LELAND C. WAECHTER, *et al.*

PRESIDING EXAMINER'S INITIAL DECISION ON JURISDICTION OVER ROYALTY OWNERS
(July 23, 1968)

KURTZ, PRESIDING EXAMINER: Involved in these proceedings is the question of the Commission's jurisdiction over the payments to holders of royalty interests in natural gas which is produced and transported in interstate commerce for resale.

The controversies arose following the decision of the United States Court of Appeals for the Fifth Circuit in *J. M. Huber Corporation v. Denman,* 367 F.2d 104 (1966). In that case the Court had before it the question of whether or not the Huber Corporation had met the terms of oil and gas leases which provided for payment of royalty based upon the market price or market value of gas produced. The Huber Corporation paid royalty based on the price it received for gas produced under the leases. Although Huber received only 4 to 11 cents per Mcf for the gas sold, the lessors, holders of the royalty interest, contended for a payment based upon an alleged market value of 23 cents per Mcf. The Court on the issue raised as to Federal Power Commission jurisdiction over the royalty interest, found the matter to be arguably within the Commission's jurisdiction and under the doctrine of primary jurisdiction, it should be referred to the Commission for initial determination.

Following the above court decision, William Harvey Denman and Joy Pumphrey, Trustees of the Estate of S. B. Burnett, deceased, and W. K. Stripling, J. B. Thomas, W. A. Landreth, W. L. Stewart,[1] and Perry R. Bass, Trustees of the Mary Couts Burnett Trust, filed on October 17, 1966 in Docket No. RI67-113, a petition for declaratory order seeking a determination that this Commission does not have jurisdiction over royalty payments

1. Mr. Stewart died on July 11, 1967.

due them as lessors from J. M. Huber Corporation, the lessee, with respect to natural gas produced and sold by the Huber Corporation to Northern Natural Gas Company for resale in interstate commerce; or in the alternative, in the event that the Commission determines that it has jurisdiction over the royalty payable under the leases to order a further hearing to determine the amount of royalty payable. The gas is produced in Hutchison and Carson Counties, Texas (Railroad District No. 10). Huber on December 8, 1966, filed an answer and a cross-complaint to the Denman petition, which was later amended on May 5, 1967, claiming, *inter alia*, that this Commission does have jurisdiction over royalty payments made to Denman, *et al.*, and that such payments must be computed on the basis of the effective rate not subject to refund, as set forth in its FPC Gas Rate Schedule No. 2. Denman, *et al.*, on December 20, 1966, filed an answer to Huber's cross-complaint.

On October 24, 1966, Mobil Oil Corporation filed a complaint in Docket No. RI67-114 to invoke the jurisdiction of the Commission over payments to Carl F. Matzen, *et al.*,[2] the owners of lessor royalty interests in natural gas produced from certain leaseholds held by Mobil in the Hugoton Field, Kansas. Matzen, *et al.*, filed an answer on November 28, 1966, alleging that this Commission has no jurisdiction over royalty payments made to them. Mobil on December 20, 1966, filed a response thereto. The complaint was initiated because Matzen, *et al.*, have filed in the courts of the State of Kansas, 283 individual suits against Mobil and one class action with the named plain-

2. Approximately 207 defendants are named and reference is made to 14 of the defendants as representatives of a class of approximately 600 landowners similarly situated.

tiffs acting in their individual capacities and allegedly representing a class of royalty owners similarly situated. Matzen, *et al.*, claim in these suits that they are entitled to royalty payments computed on the basis of rates in excess of the effective rates under Mobil's FPC Gas Rate Schedule Nos. 3, 281, and 282.

On February 23, 1967, Western Natural Gas Company filed a complaint in Docket No. RI67-310 to invoke the jurisdiction of the Commission over payments to Elmer Hennigh, *et al.*,[3] the owners of lessor royalty interests in natural gas produced in the Hugoton Field, Kansas. Hennigh, *et al.*, filed an answer to Western's complaint on March 30, 1967, alleging the Commission is without jurisdiction over the royalty payments. Western filed a response thereto on April 14, 1967. Western's complaint followed a suit brought on April 22, 1965, by Hennigh, *et al.*, against Western in the District Court of Grant County, Kansas, in which they claim royalty payments in excess of the effective rate not subject to refund, as set forth in Western's FPC Gas Rate Schedule No. 17.

On May 11, 1967, Pan American Petroleum Corporation filed a complaint in Docket No. RI67-400 requesting the Commission to institute a hearing to determine whether it has jurisdiction over payments of royalty to Leland Waechter, *et al.*,[4] on gas produced in the Hugoton Field, Kansas. Waechter, *et al.*, filed an answer on June 20, 1967, in which it was asserted that the Commission has no jurisdiction over the controversy. The complaint followed a suit by Leland C. Waechter, *et al.*, against Pan American, in the District Court, Stevens County, Kansas,

3. 15 additional defendants are named.

4. 273 additional defendants are named.

in which they assert the right to collect royalty payments in excess of the effective rate not subject to refund, as set forth in Pan American's FPC Gas Rate Schedule No. 84.

The above dockets were consolidated by Commission orders of April 3, 1967 and June 23, 1967. These proceedings include 34 petitions to intervene, four petitions seeking leave to file amici briefs, and four notices of intervention. On May 8, 1967, the Commission granted the petitions to intervene and the right to file the amici briefs.

In support of the position that the Commission has jurisdiction over royalty payments on gas moving in interstate commerce and resold, briefs have been filed in the consolidated proceedings by the Staff, The People of the State of California and The Public Utilities Commission of the State of California, J. M. Huber Corporation, Western Natural Gas Company, Pan American Petroleum Corporation, Continental Oil Company, Shell Oil Company, Mobil Oil Corporation, Sinclair Oil & Gas Company, Ashland Oil & Refining Company, Cities Service Oil Company and Columbian Fuel Corporation, Northern Natural Gas Company, Eastern Distributor Intervener Group,[5] Tenneco Oil Company and Texas Independent Producers & Royalty Owners Association.[6]

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5. The Brooklyn Union Gas Company, Consolidated Edison Company of New York, Inc., Long Island Lighting Company, Orange and Rockland Utilities, Inc., Philadelphia Electric Company, Philadelphia Gas Works, Division of The United Gas Improvement Company, and Public Service Electric and Gas Company.

6. A nonprofit association representing approximately 4,500 members of which 2,000 are nonintegrated independent producers and 2,500 are royalty owners with mineral interests covering developed or potential crude oil or gas production or both.

The following parties filed briefs in opposition to Commission jurisdiction: William Harvey Denman, *et al.*; Named Defendants in Docket Nos. RI67-114, RI67-310 and RI67-400; Terry Thompson, Jr., Lillian Blanche Brent, R. P. Brent, Jr., Phillip Thompson and L. A. White, Trustee for Miss Georgia Thompson; Old Ocean Royalty Owners Association;[7] and The Land and Royalty Owners of Louisiana.[8]

The order issued April 3, 1967, setting this matter for hearing limited the question at issue and confined the hearing, as follows:

> "Though there may be certain factual differences, the same basic question is presented by the complainants filed by Mobil and Western Natural and the Denman petition: can persons contractually entitled to royalty payments for natural gas sold for resale in interstate commerce be classified as 'natural-gas companies' within the meaning of the Natural Gas Act and subject to the jurisdiction of the Commission. It is therefore appropriate to consolidate these proceedings for hearing as hereinafter ordered. The issuance of this hearing order should not be viewed as the enunciation of the Commission's tentative position that we have jurisdiction over royalty owners. The Commission has not as yet made any such determination of the jurisdictional question and will not until consideration of this proceeding.
>
> "The hearing in these cases shall be confined to resolving whether the Commission has jurisdiction

7. Association of over 300 royalty owners in the Old Ocean Field located in Matagorda and Brazoria Counties, Texas.

8. A nonprofit corporation with members comprised of owners of lands and minerals and royalties affecting more than one million acres of land located in Louisiana.

over a landowner's royalty interest in natural gas leaseholds, and, if answered in the affirmative, how such jurisdiction should be implemented. More specifically the parties should address themselves to the method which should be used in computing gas royalty payments and what additional filing requirements, if any, should be imposed and upon whom.[1]

The Commission specifically in the above hearing order excluded: (1) any question as to its jurisdiction over royalty interest owned by a State, the United States, or their agencies; (2) contractual issues relating to specific royalty payments to which any particular royalty owner is entitled under a lease agreement; and (3) any question relating to helium except "as the facts on this subject bear upon the royalty interest of landowners in natural gas leaseholds."

By order issued June 23, 1967, the Commission reiterated the question at issue stating: "The common question presented is whether royalty payments made to the lessors named in these proceedings are subject to this Commission's jurisdiction under the Natural Gas Act." It authorized evidence relating to the general industry contracting practices with respect to gas leases so as to be more fully informed as to the general background of the problem and possible economic and legal consequences before making its determination.

There is considerable evidence in the record relating to general industry contracting practices with respect to basic provisions in oil and gas lease agreements. Every

1. For example, assuming that the lessor-lessee sale is jurisdictional it may, nevertheless, not be necessary for the royalty owners to make any filing with this Commission. See Section 154.91(e) of our Regulations under the Natural Gas Act."

provision in a lease is open to negotiation, but not every provision is actually negotiated in every transaction. The most common items of negotiation between the lessor and prospective lessee are the amount of cash bonus, the amount of delay rental, the length of the primary term, and the royalty fraction.

The cash bonus is the cash consideration paid by the lessee to the lessor for granting the mineral lease and may range from a minimal amount to a substantial sum.

The delayed rental is a payment for the privilege of deferring the commencement of drilling operations or the commencement of production.

The primary term is the term of the lease during which the lease may be continued in effect without drilling operations or production by the payment of a delayed rental. The primary term in South Louisiana is usually a period of from 1 to 10 years. There is usually some delay between the granting of a lease and the production and sale of the natural gas.

The landowner may create by grant or by reservation various estates in land. The interest we are concerned with here is called royalty[9] and is created by a reser-

9. "The term 'royalty' comes down to us through the channels of the old common law of England and its derivation is interesting. Under the theory of land tenure under the feudal system in force and effect in England during the early middle ages, the title to the manor and 'royal mines' of gold and silver was vested in the crown by royal prerogative and, being subject to alienation at his pleasure, was held in fief by the tenants who worked the mines and cultivated the lands under the feudal lords. The tenant held only a 'working interest' so to speak, and produced the crops at his own labor and expense, while the landlords or royal fee owners, holding title direct from the crown, reserved their share of the product of the soil, which

vation in an oil and gas lease in which the landowner grants to the lessee certain rights and privileges, such as, to explore, drill and produce oil and gas, and in the same instrument reserves to himself, free from the expenses of production, a share in the oil and gas produced or the proceeds thereof. Williams and Meyers, *Oil and Gas Law*, Manual of Terms, 342; Volume 1, sec. 202, 202.1, 202.3. This share is usually expressed in terms of a fraction of the production. The fraction is generally one-eighth and in some instances a larger amount. The royalty interest as to oil produced is usually taken in kind, but as to gas produced, while the right to take in kind may be reserved, it is seldom done as a practical matter due to its characteristics and the lack of market other than the pipeline to which the lessee delivers the gas. The common provisions in the leases for accounting to the lessor for royalty as to the gas produced provide for the lessee to pay the lessor for his fractional part the market value in the field or a percentage of the proceeds derived from the sale of the gas.

In addition to the lessor's royalty interest, there is also another type of royalty interest called an overriding royalty interest. Such interest is most commonly created when a lessee enters into a farmout agreement with another producer. In such an agreement the lessee retains either an undivided interest in the leases or an override interest. Both the lessor royalty interest and the overriding royalty interest as a contractual matter receive their respective interests free of any of the costs of production, except for taxes. The working interest owners

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share was termed a 'royalty' or that portion belonging to the landlords under royal grant or favor." (Glassmire, *Oil and Gas Leases and Royalties*, Second Edition, page 61).

generally share the expenses of development and operation of the propery, proportionate to their interest in the property. Although the overriding royalty interest owner is a bare holder of a right to receive proceeds, the lessor royalty interest owner is protected by certain implied covenants with respect to the development of a lease and the marketing of the product.

In Docket No. RI67-113, there are involved three leases as to mineral rights in Texas, designated as the "R Lease" entered into on June 2, 1936, the "B Lease" and the "M Lease" on January 22, 1926. The royalty provision insofar as necessary for consideration here, under the "R Lease" which accounts for 93 percent of the production of gas provides for Huber, the leasee:

> "To pay the Lessors monthly for one-fourth (¼) of the gas produced at the mouth of the well from any gas well, where gas only is found, four cents per one thousand cubic feet for the first ten years of this contract, and thereafter, the market price of such gas but in no event shall the price be computed at less than four cents per one thousand cubic feet."

Under the B and M Leases the royalty clause provides:

> "To pay the Lessor the equal one-eights part of the market value in the field for the gas from each well where gas only is found, while the same is being used off the premises, * * *"

The type of lease varies as to mineral rights in Kansas under Docket Nos. RI67-114, RI67-310 and RI67-400. The royalty clauses in the leases here necessary for consideration generally provide for the lessee to pay the lessor on gas marketed from each well where gas only

is found one-eighth of the proceeds if sold at the well, or if marketed by the lessee off the premises, then one-eighth of its market value at the well. Some of the leases set forth only a proceeds type royalty clause and others only a market type royalty clause. Regardless of the type of royalty clause set forth in the leases involved in these proceedings, the landowners claim entitlement at the market price.

Under the royalty owners contention, the royalty percent age of the gas sold to the ultimate consumers, 12½ percent or over, will be contractually removed from effective Commission regulation of pipeline gas purchase costs. Payment of the royalty percentage at a higher rate than that prescribed in producers rate schedules as here sought by the royalty owners will affect the cost of gas and ultimately be reflected in rates paid by the consumers in other States.

The main thrust of the royalty owners in opposing Commission jurisdiction is simply that the landowner by the retention of a royalty interest is not the owner of any portion of the gas produced and thus he has nothing to sell. The proponents of jurisdiction advance various arguments against the position taken by the royalty owners and contend that a sale occurs, with some referring to the relationship between the lessor and lessee as that of a cotenancy and also as a joint enterprise.

Whatever may be the rights and obligations of the lessor and the lessee under State law, the issue as to the Commission's jurisdiction must be determined under the provisions of the Natural Gas Act. This was pointed out in *United Gas Improvement Co. v. Continental Oil Co.*, 381 U.S. 392, 400, (1965) the Court stating:

> "Without impugning in any way the good faith and genuineness of the transactions, we think it clear that the lease-sales here in question can nonetheless be considered 'sales' of natural gas in interstate commerce for purposes of the Act. A regulatory statute such as the Natural Gas Act would be hamstrung if it were tied down to technical concepts of local law."

Nor can an "attractive gap" in Commission jurisdiction be created by ability to frame contractual arrangements to exclude significant portions of jurisdictional gas from regulation. *California v. Lo-Vaca Co.*, 379 U.S. 366, 369-370 (1965) Jurisdiction under the Natural Gas Act is not dependent upon the form of the royalty payment set forth in the lease. The Commission in *Texas Eastern Transmission Corporation, et al.*, 29 FPC 249, 256[10] in holding sales of reserves as being subject to its jurisdiction stated:

> "Any other result would exalt form over substance, would give greater weight to the technicalities of contract draftmanship than to the achievement of the purposes of the Natural Gas Act, and would impair our ability to control the price received for gas sold to the pipelines in interstate commerce to the detriment of the ultimate consumer. Control limited to approving the costs of the gas to the purchasing pipeline is, of course, not an effective way to regulate producer prices because in the large a pipeline must be allowed to pass on its purchased gas costs to the ultimate consumer or it cannot continue to discharge its public service responsibilities."

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10. This decision was affirmed in *United Gas Improvement Co. v. Continental Oil Co.*, 381 U.S. 392 (1965).

The Commission's regulation of the sales by independent producers began in 1954, after the Supreme Court's decision in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, (1954). Until now the Commission has not been faced with a claim for royalty payment based on a rate in excess of that which the lessee-producer is authorized to collect. The Commission has exercised jurisdiction and required the royalty holder to obtain a certificate of public convenience and necessity, where the lessor has the right, if exercised, to have his fraction of the gas produced delivered to him in facilities at the well provided by him for that purpose.[11]

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11. On June 3, 1957, in Elk River Coal & Lumber Company (now The Pittston Company) Docket No. G-11462, and on March 23, 1959, in Northern Natural Gas Producing Company, Docket No. G-10001, the Commission found these companies to be Independent Producers of natural gas by reason of the sale of royalty interest gas and issued certificates of public convenience and necessity. Elk River on December 26, 1940, entered into an oil and gas lease with Pittsburg and West Virginia Gas Company (now Equitable Gas Company) and reserved to itself one-eighth (1/8) part or share of all natural gas produced and saved from the leased acreage. The lease provided that Elk River for its interest in gas not taken by it was deemed to be sold to Pittsburg and West Virginia and was to be paid for at the wholesale field market value of natural gas at well. Pittsburg and West Virginia took the seven-eighths interest of the gas which it owned, together with the one-eighth royalty interest and transmitted the eight-eighths of the natural gas in interstate commerce for resale. Northern Natural Gas Producing Company's application involved five contracts covering an overriding royalty interest of 1/16th of 7/8ths in the gas produced from nine wells and it requested a disclaimer of jurisdiction; or, in the alternative a certificate authorizing the sale. The royalty interest was sold by Northern to its parent, Northern Natural Gas Company, and the gas was transported in interstate commerce for resale. At the time of the issuance of a temporary certificate to Northern and the acceptance of Elk River's increase rate filing in 1956, Commissioner Digby filed a protest as to the Commission "policy decision" exercising jurisdiction over the royalty interests involved.

The declared purpose of the Natural Gas Act, Sec. 1(a) is to regulate matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce.

A natural-gas company is defined by the Natural Gas Act, Sec. 2(6) to mean a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale. The jurisdiction of the Commission is set forth in Sec. 1(b) as follows:

> "The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas."

The Commission's jurisdiction attaches to sales of natural gas in interstate commerce for resale. The Court in construing the above section has pointed out a number of times that the Natural Gas Act is applicable to three separate things: (1) the transportation of natural gas in interstate commerce; (2) its sale in interstate commerce for resale; and (3) natural gas companies engaged in such transportation or sale. They are independent and equally important regulatory powers under the Act. *Panhandle Eastern Pipe Line Co. v. Public Service Commission*, 332 U.S. 507, 516 (1947); *FPC v. East Ohio Gas*

Co., 338 U.S. 464, 468 (1950); *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 681 (1954).

The royalty owners rely upon *Federal Power Commission v. Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, (1949), which involved the transfer of undeveloped leaseholds from a natural-gas company to its wholly owned subsidiary for sale of the gas in intrastate commerce. This was held not subject to Commission jurisdiction, since it was within the production and gathering exemption of Sec. 1(b) of the Natural Gas Act. The royalty owners' position is that since the sale and conveyance of an existing oil and gas lease on undeveloped land is outside the jurisdiction of the Commission, it follows that the creation of the lease-hold is likewise outside such jurisdiction. This case is not applicable as we are here concerned with gas moving from developed leases in interstate commerce. This same argument was advanced in *United Gas Improvement Co. v. Continental Oil Co., supra*, 402-404 and the Court refused to accept such an interpretation as it would make Phillips[12] a shadow and subject to a matter of timing of the title transfer. The Court went on to state that even though a sale occurs before production and gathering is ended, it is nevertheless subject to regulation, as the production or gathering exemption relates to the physical activities, processes and facilities of production and gathering, but not to sales of the kind affirmatively subjected to Commission jurisdiction.

In *Atlantic Refining Co. v. Public Service Comm'n*, 360 U.S. 378, 388-389 (1959), the Court referred to the purpose of the Natural Gas Act, as follows:

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12. *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954).

> "The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges. * * *
> "The overriding intent of the Congress to give full protective coverage to the consumer as to price is further emphasized in § 5 of the Act * * *."

This protection of the consumer, which is the primary aim of the Natural Gas Act, extends to the regulation of all wholesales of natural gas in interstate commerce, whether by a pipeline company or not and whether occurring before, during, or after transmission by an interstate pipeline company. *Phillips Petroleum Co. v. Wisconsin, supra,* 682, 685 (1954).

The Supreme Court also pointed out in the recent *Permian Basin Area Rate Cases,* ____U.S.____, decided May 1, 1968, that it has repeatedly held that the width of administrative authority must be measured in part by the purposes for which it was conferred and the Commission's broad responsibilities demand a generous construction of its statutory authority.

The question of jurisdiction presented in these proceedings does not begin to approach the extent of the Commission's jurisdiction as set forth in *United Gas Improvement Co. v. Continental Oil Co., supra,* 401 (1965). The Court's opinion pointed out the history of the transactions leading up to sale of the leases. Regardless of all this, the Court laid down the rule as to jurisdiction, as follows:

> "But it is perfectly clear that the sales of these leases in Rayne Field, a proven and substantially developed field, accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other States. That is the significant and

> determinative economic fact: To ignore it would substantially undercut *Phillips,* and because of it the Commission * * * acted properly in treating these sales of leasehold interests as sales of natural gas within the meaning of the Natural Gas Act."

In a summary opinion, based on the above case, the Court also affirmed the Commission's opinion (30 FPC 1477) holding that it had jurisdiction over the transfer of the Bastian Bay Field leases. *Federal Power Commission v. Pan American Petroleum Corp.*, 381 U.S. 762 (1965).

In *Continental Oil Co. v. Federal Power Commission,* 370 F.2d 57, 61-62, cert. denied, 388 U.S. 910 (1967), the Court having before it Continental's transfer in the form of lease-sale agreements of certain leasehold interests in the Ship shoals Field held them to be a sale of natural gas in interstate commerce within the meaning of Sec. 1 (b) of the Natural Gas Act pointed out that the test is not whether the transaction in question is in form a lease-sale or a sale of gas, as the transaction may be a lease-sale in accordance with the local law and a sale of gas under the Act and stated: "The test is three-pronged: (1) Is the economic effect of the transfer similar to that of a conventional sale? (2) Is the subject of the transaction 'proven and substantially developed' reserves? (3) Is the transfer of the reserves for purpose of interstate transmission and resale?"

The result of the leases here involved is that the interests of both the lessor and lessee in gas produced and sold accomplishes the transfer of natural gas in a continuous flow to an interstate pipeline company for resale in interstate commerce.

The royalty owners do not and cannot claim that the gas is not in interstate commerce. It is immaterial at what point the royalty interest is "sold". In *Deep South Oil Co. of Texas v. Federal Power Com'n*, 247 F.2d 882, 887 (1957) the Court states:

> "The fact that the sales are made at the wellhead is immaterial for the particular point at which the title and custody of the gas pass to the purchaser, without arresting its movement to the ultimate interstate destination, does not affect the essential interstate nature of the business."

By the terms of the lease the royalty owner has a continuing interest in production as the payment flows from acquisition by interstate pipelines of gas for resale for ultimate public consumption. The leasee must account to the lessor for his share of the volumes of gas produced and compensate the lessor for his retained fraction of the production. The effect is the same as a conventional sale of gas by the lessor to the leassee. To hold that the Commission does not have jurisdiction would defeat the purpose of the Act by a failure to plug a "gap" in the regulation of natural gas. This is clear from *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954). In *FPC v. Transcontinental Gas Corp.*, 365 U.S. 1, 28 (1961) the Commission was concerned with the effects that a certificate might have in the future on field prices generally, and the Court stated:

> "The point is, as we have stated, that Congress did not desire an 'attractive gap' in its regulatory scheme; rather, Congress intended to impose a comprehensive regulatory system on the transportation, production, and sale of this valuable natural resource.

> Therefore, when we are presented with an attempt by the federal authority to control a problem that is not, by its very nature, one with which state regulatory commissions can be expected to deal, the conclusion is irresistible that Congress desired regulation by federal authority rather than non-regulation. See *Panhandle Eastern Pipe Line Co. v. Federal Power Comm'n*, 232 F.2d 467."

This continuing interest of the royalty owner in rate matters before the Commssion is also set forth in the brief filed by Old Ocean Royalty Owners Association, as follows: (p. 4)

> "For the most part, those parties taking part in such settlement negotiations simply concerned themselves with the 'area' effect and the overall dollar impact of the entire settlement package. Thus, to such negotiators, a settlement price for one sale, standing alone, had little material significance. This is, of course, directly contrary to the position of royalty owners in a particular leasehold covered by a particular sale, which such royalty owners have as a minimum a ⅛th monetary interest in the gas involved in their particular sale. In spite of their vital and material interest in the terms of any settlement, royalty owners have thus far been excluded from settlement negotiations and afforded no opportunity to object to any of the terms of a settlement prior to its approval by the Commission.
>
> "Therefore, regardless of the ultimate answer to the question of whether the Commission has jurisdiction over royalty interests in leaseholds from which interstate sales of gas are made, it is necessary and proper, and the Presiding Examiner should so recommend, that the Commission amend its regulations so as to provide, in effect, that any independent producer proposing to enter into negotia-

tions for a settlement covering and relating to one or more jurisdictional sales of gas be required to give notice to such effect to all of such independent producer's royalty owners to be affected thereby. Such a regulation would enable a royalty owner to at least have an opportunity to protect his interest in any proposed settlement, and thus do away with the practice to date of simply informing the royalty owner, after the fact, that his interests have been bargained with by other parties at settlement conferences of which he had no notice. The inequities of the present practice are too obvious and too blatant to be any longer ignored."

The consumer for whom the Natural Gas Act is designed to protect has a real interest in the amount paid for royalty, by reason of the royalty owners now attempting to force the payment for the royalty fraction to a higher rate than that named in filed rate schedules of the producer. The market price for gas, as can be expected, in the unregulated market is higher than allowed under regulation by the Commission. This is not only evidenced by the suits which gave rise to this proceeding but also as shown in the brief above referred to filed by the Old Ocean Royalty Owners Association. Therein it was pointed out that in 1966 over 88,000,000 Mcf of gas was taken from the Old Ocean Field of which over 41,000,000 was sold in interstate commerce to the Natural Gas Pipeline Company of America at 11.4 cents per Mcf and in excess of 47,000,000 Mcf was sold in intrastate commerce at higher prices.

Considering the volumes of gas that move in interstate commerce and the uncertainty of the price to be paid for the royalty interest, which has a direct and substantial effect on the price paid by the ultimate consumer,

the Commission must now exercise its jurisdiction to insure the reasonableness of price for gas to the consumer.

Denman, *et al.*, and The Land and Royalty Owners of Louisiana cite *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) as holding that the Supreme Court recognizes that Congress was not concerned with royalty owners, or any others, who might have a collateral economic interest in the production and sale of natural gas. This case does not support such a conclusion but quite the contrary. The quoted statements from the *Hope* case refers to the position of West Virginia, which was requesting the Commission to allow a market price in the field higher than the costs of gas transported by Hope so as to promote the economy of the State. While the Court recognized that both the lessor and lessee had valuable property interest in the gas which was separately taxable under West Virginia law, it could not find in the words of the Act or in its history the slightest intimation or suggestion that the exploitation of consumers by private operators through the maintenance of higher rates should be allowed to continue provided the producing states obtain indirect benefits from it.

A further statement as to the position of West Virginia in the *Hope* case is found in *Columbus, Ohio v. United Fuel Gas Co.*, 5 FPC 279, 292 (1946) wherein the Commission pointed out:

> "In addition to the contentions of West Virginia agencies that the price of gas at the well mouth should be fixed at 15 cents per M.c.f., which we have previously discussed, these parties contend that in determining reasonable rates for the respondents,

production must be entirely separate from transportation and distribution, and that the formula heretofore applied by this Commission for determining the cost of production is of improper applicability. These same contentions were advanced by the State of West Virginia and the Public Service Commission of West Virginia in *Federal Power Commission v. Hope Natural Gas Company* (320 U.S. 591), and the Court said:

> 'We have considered these contentions at length in view of the earnestness with which they have been urged upon us. We have searched the legislative history of the Natural Gas Act for any indication that Congress entrusted to the Commission the various considerations which West Virginia has advanced here. And our conclusion is that Congress did not.'"

The Land and Royalty Owners of Louisiana in support of its position that the legislative history discloses an intent of Congress not to include the holders of royalty interests within the jurisdiction of the Commission, calls attention to the Crosser Bill (H.R. 5711, 75th Congress, 1st Session) and the Lea Bill (H.R. 4008, 75th Congress, 1st Session, the forerunner of the Natural Gas Act).[13] The Crosser Bill was not enacted or even seriously considered. During the hearing on the Lea Bill language from the Crosser Bill requiring the filing of contracts including lease and royalty agreement was sought as an amendment to what is now Sec. 4 of the Act, which relates to the establishment of rates and charges. This proposal as to the filing of such agreements was objected to by Mr. William Dougherty, representative of the pipe-

13. The Lea Bill as amended became H. R. 6586, 75th Congress, 1st Session.

line companies, on the grounds of additional expense and such filings were of no value until there was a rate case and if need they could be obtained at that time. The mandatory filing proposed under this section was not adopted. The proposal to include the right of the Commission to require the filing of lease and royalty agreements with respect to a determination of gas reserves in what is now Sec. 14(b) was adopted. Neither of these proposals support the position of The Land and Royalty Owners.

The claim is advanced that the failure of the Commission to assert regulatory jurisdiction over royalty prices is persuasive as to the lack of such jurisdiction. The short answer to this is, except for the *Northern* and *Elk River* instances, the Commission has not heretofore been called upon to pass on the jurisdictional question. Nor has it been faced with a claim for the payment of royalty at a rate in excess of that which the producer is authorized to collect.

Various proposals have been made as to how jurisdiction over the royalty interest should be implemented. Some proposals would effect a determination of contractual issues relating to specific royalty payments to which a particular royalty owner is entitled under a lease agreement by restricting payment to the level of the rate received by the producer or the area rate named by the Commission. Such a determination of specific royalty payments was excluded from consideration herein by the above Commission hearing order. The royalty interest is similar in many respects to a percentage interest held by an independent producer in a lease who is not a signatory to a gas sales contract. Under Section 154.91 (d)

of the Regulations under the Natural Gas Act applicable to producers, a non-signatory interest owner to a jurisdictional gas sales contract is not permitted to file a certificate application or rate schedules in the absence of a waiver for good cause (see Rules of Practice and Procedure, Section 1.7(b)). This practice was upheld in *Sun Oil Co. v. FPC*, 256 F.2d 233, *cert. denied*, 358 U.S. 872 (1958). This is the same approach that the Commission has taken with respect to percentage sales contracts between a producer and the operator of a processing plant where the producer sells its gas to the plant operator at a price that is determined on the basis of a percentage of the proceeds from the jurisdictional resale of the residue gas by the plant operator (see Section 154.91(e) of the Regulations under the Natural Gas Act). The Commission's Regulations do not presently provide for separate filings by royalty owners who are not themselves signatory parties to the gas sales contract.

The burdening of the Commission and royalty owners as to filing requirements should be avoided as far as feasible. It would appear that the Commission's processes need be invoked only in those instances where the royalty owner asserts a claim for a higher price for his fractional share of the gas over that which the producer or lessee is authorized to secure. It is not necessary or advisable at this time to adopt requirements governing royalty interest beyond recognizing the right of the royalty owner to file for an increase. Any regulations beyond this should be based upon a general rule making proceeding applicable to all royalty owners.

ADDITIONAL FINDINGS AND CONCLUSIONS

Upon consideration of the record and the briefs filed

in these proceedings it is further found and concluded that:

(1) The provisions of the Natural Gas Act apply to persons entitled to royalty payments for natural gas sold for resale in interstate commerce and the royalty payments are subject to the jurisdiction of the Commission under the Act.

(2) No additional regulation governing filing requirements are required at this time, except as hereinafter ordered.

ORDER

WHEREFORE, IT IS ORDERED, subject to review by the Commission:

(A) The royalty owners in Docket Nos. RI67-113, RI67-114, RI67-310 and RI67-400 are natural gas companies as defined in the Natural Gas Act.

(B) A royalty owner seeking an increase in the royalty payment over and above that received from the producer shall set forth in the application to the Commission the existing rate of payment per Mcf, the higher rate of payment claimed and the factual information relied upon in support of the increase, including all agreements relating to the royalty interest.

/s/ Alvin A. Kurtz
ALVIN A. KURTZ
Presiding Examiner

APPENDIX D

J. M. HUBER CORPORATION, Appellant,

v.

William Harvey DENMAN and Jay Pumphrey, Trustees of the Estate of S. B. Burnett, Deceased, et al., Appellees.

No. 22272.

UNITED STATES COURT OF APPEALS
Fifth Circuit.

(367 F.2d 104)

Sept. 20, 1966.

Before RIVES, BROWN and MOORE,* Circuit Judges

JOHN R. BROWN, Circuit Judge.

As with another case this day decided,[1] this one, thought by the parties to be a private controversy, turns out to have transcendent public interest issues. In each, besides deciding the private law questions, we direct a reference to the Federal Power Commission for it to determine under the doctrine of primary jurisdiction the jurisdiction of the FPC over rates to be paid for gas royalty. Post argument consideration led the Court to the view that in the ultimate resolution of private law issues, there were problems of great public interest. The Court by memoranda

* Of the Second Circuit, sitting by designation.

1. Weymouth v. Colorado Interstate Gas Co., 5 Cir., 1966, 367 F.2d 84.

to counsel in this and *Weymouth* (see note 1, supra) called for, and we have received, extensive helpful briefs.[2]

I.

The Market Price Royalty Clause

The basic private legal question presented is whether under the terms of the oil and gas lease from Lessors to Lessee-Producer the amount payable as royalty is to be fixed by the stated percentage (¼th) of (a) the price received by the Lessee from its Pipeline Purchaser or (b) the market price for like gas in the field.[3] This turns on the construction of the lease terms in the light of all pertinent factors.

It sharpens the relevance of facts and the significance of the trial Court's actions to bear in mind that the royalty clause in question prescribed (a) a fixed price for a ten-year period and thereafter for the period in controversy (b) the market price of such gas, but not less than the specified minimum.[4] The Lessors contend that it is the

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2. These included the formal brief of the FPC (with separate statement of Commissioner O'Connor) filed in response to the Court's express request and full exchange of briefs of all counsel in both cases on the FPC issue.

3. Lessor — Burnett Estate
Lessee-Producer (the Producer status under FPC) — Huber
Pipeline Purchaser — Northern Natural

4. The gas royalty clause reads as follows:
"To pay the Lessors monthly for one-fourth (¼) of the gas produced at the mouth of the well from any gas well, where gas only is found, four cents per one thousand cubic feet for the first ten years of this contract, and thereafter, the market price of such gas, but in no event shall the price be computed at less than four cents per thousand cubic feet."
Of production at issue 93% is from the R-Lease, the balance from the B and the M Leases which provided a ⅛ royalty "of the market value in the field," etc.

market price[5] without limitation to the actual proceeds while the Lessee-Producer urges that the value is fixed by the proceeds received by it from its Pipeline Purchaser.

It likewise streamlines our task to emphasize what the quarrel is not about. Contrary to the sometime colorful charges of the Lessor, the Lessee-Producer does not undertake to say that this clause (note 4, supra) is a "proceeds" rather than a "market price" standard. The Lessee-Producer gears royalty payments to the proceeds from the Pipeline-Purchaser, not because it is a "proceeds" clause, but, rather, because contemporaneous actions and other agreements limit "the market" to that afforded under the Northern Gas contract. The Lessee-Producer refuses, therefore, to get drawn into the academic debate pressed so hard by the Lessors that a market price clause is quite different from a proceeds clause.[6] Indeed, rather than disputing this recognized distinction, the Lessee-Producer asserts that because of other circumstances later discussed the terms "market price" and "market value" were not intended consensually to be used in their usual and ordinary sense. That sense is stated to be the "price at which willing buyers at or about the time of deliveries of gas produced from the leases were agreeing to pay willing

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5. For our purposes the distinction between market "price" and "value" is of no consequence. For simplicity all references will be to "market price."

6. The Lessors stress the following: Phillips Petroleum Co. v. Bynum, 5 Cir., 1946, 155 F.2d 196, 201; Union Producing Co. v. Pardue, 5 Cir., 1941, 117 F.2d 225, 227; Wall v. United Gas Public Service Co., 1954, 178 La. 908, 152 So. 561; Phillips Petroleum Co. v. Johnson, 5 Cir., 1946, 155 F.2d 185, 188, 189; W. R. Davis, Inc. v. State, 1944, 142 Tex. 637, 180 S.W.2d 429, 432; Foster v. Atlantic Refining Co., 5 Cir., 1964, 329 F.2d 485, 489; Sneed, Value of Lessors Share of Production Where Gas Only Is Produced, 25 Tex. Law Rev. 641, 646 (1947). See also, Brown, The Law of Oil and Gas Leases, 1958, §§ 6.09, 6.10.

sellers for comparable gas." This contention is a paraphrase of issues No. 2 and 3 out of the four stipulated to be tried by the District Judge and which he answered adversely to Lessee-Producer.[7]

In attacking the findings that it is the "market price" in the traditional legal sense, not the equivalent of the proceeds received from the Pipeline-Purchaser, the Lessee-Producer capsulates it in three steps: (1) this gas has a specific market, i. e., the Northern contract; (2) the market price of such gas is the amount received for the gas delivered to this specific market; (3) the Lessors, because

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7. The four stipulated issues were:

ISSUE NO. 1

Whether primary administrative jurisdiction of the subject matter is vested in the Federal Power Commission under the Natural Gas Act, 15 U.S.C.A., Secs. 717, et seq.

ISSUE NO. 2

Whether the payment of gas royalties to plaintiffs computed on the proceeds derived from the delivery of the gas produced from the wells described in the Amended Complaint to Northern Natural Gas Company in compliance with the "Northern Contract," as amended, fully satisfies all the express and implied obligations of defendant under the terms of the several leases, as amended, which leases are described in the Amended Complaint in respect to the marketing of gas production therefrom and the payment of royalty thereon, irrespective of the market price or the market value in the field of such gas or of gas generally.

ISSUE NO. 3

Whether the plaintiffs are legally entitled to collect royalty from defendant computed at a value or price in excess of the applicable effective rate, if any, under the Natural Gas Act, pursuant to the Rules and Regulations of the Federal Power Commission as to gas delivered under the "Northern Contract" to Northern Natural Gas Company, irrespective of the market price or the market value in the field of such gas or of gas generally.

ISSUE NO. 4

Whether the said gas division orders dated December 27, 1945, identified as Stipulation Exhibits Nos. 48, 49, 50, 51, 52 and 53 were in effect and binding on the plaintiffs on and subsequent to January 1, 1958.

of affirmative participation in the commitment of the gas to this specific market cannot claim there is a market other than the Northern contract. Elaborating, the contention runs, this is not an argument as to the difference in legal concept of "market price" and "proceeds received" clauses. Rather, the question for decision is whether, under the particulars of this case, the Northern Contract market is *the market* from which the market price is to be taken.

The circumstances surrounding the affirmative participation of the Lessors in the commitment of the gas to this particular market as reflected by the stipulation record may be briefly summarized In early 1936 Lessee-Producer was negotiating with the Lessors for a lease on approximately 6,120 acres of unleased land overlying the Panhandle Gas Field of Texas, some of the land being in the sweet gas area and some of the land in the sour gas area of this Field. During such negotiations, Lessee-Producer was advised by the Lessors that, as a condition precedent to the making of such lease and as a part of the consideration for such lease, Lessee-Producer must have a positive contract with a pipeline company to take the production from the unleased area after it might be developed.

In order to meet this condition precedent and to establish a positive contract with a pipeline company, Lessee-Producer, on April 21, 1936, entered into the Northern contract with Northern Gas, an interstate pipeline company, even though at that time Lessee-Producer had no lease and no binding agreement to obtain one from Lessors. On June 2, 1936, 42 days after the Northern Gas Contract was arranged, the Lessors delivered the "R-Lease to Lessee-Producer.

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8. Northern Natural Gas Company was then known as Northern Fuel Supply.

Two provisions of the R-Lease are particularly stressed the first being the gas royalty clause (note 4, supra) and Sec. IX which referred to the preexisting Northern contract demanded as a condition precedent to the lease.[9] Subsequent contractual agreements between these parties also referred specifically to the Northern contract.[10]

Considering the fixed royalty of 4¢ for the first 10-year period expiring June 2, 1946 (note 4, supra), it is significant that under the Northern contract Lessee-Producer was to receive only 3½¢ per MCF until December 26, 1945, and from December 27, 1945, 4¢ for the remainder of the term of the contract (defined to be life of the leases to which it applied). In 1961 the contract price was renegotiated to 11¢ MCF and after FPC approval, this price was received. During the first 10-year period, the fixed royalty of 4¢ was paid, and no dispute exists as to it. Thereafter until 1961 Lessee-Producer paid royalty at 4¢ and after the 1961 increase on the basis of 11¢.

Against this background, the Lessee-Producer contends that these affirmative contractual actions permanently

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9. Section IX of the lease relating to the marketing of gas production reads:

> "A contract for the sale of sweet gas produced from that portion of this lease which lies within what is now known to be the sweet gas area has been entered into between the Northern Fuel Supply Company as buyer and J. M. Huber Petroleum Company, which is the operating subsidiary of Lessee, as Seller. A true and correct copy of said gas sale contract has been furnished by the Lessee to the Lessor."

10. This included the August 10, 1938, lease in which Lessee-Producer undertook to drill and complete a well on the portions then leased and, if productive, "to proceed to deliver gas therefrom under its contract with the Northern Fuel Supply Company." Cited also are the unitization agreements of January 20, 1939 and November 2, 1939.

channeling the gas into the Northern contract bound the Lessor to accept the Northern contract as the sole and exclusive market. As such, these actions constitute as a matter of law, first, an express adoption of the contract, second, a ratification of it, and third, an estoppel to assert that the gas has any other market as between the parties.

In passing upon the stipulated issues 2 and 3 (see note 7, supra), the trial Court made categorical findings of fact that the Lessors, in executing, and the Lessee-Producer in accepting the R-Lease (and two others) intended to use the terms "market price" and "market value" in their usual and ordinary sense and not as synonymous with or identical to proceeds received under the Northern contract.

[1-3] When we bear in mind that in construing the contract, the Court is to put itself in the position of the parties[11] and that the construction put on the contract by responsible action of the parties is frequently the best revelation of its purpose, we think there were ample evidential facts to justify the Judge concluding that the literal terms, generally so well recognized in oil and gas law, should be given their literal meaning. There was, first, the fact that this lease was the product of extended negotiations conducted under the skilled eyes and hands of highly competent oil and gas lawyers. Realizing as they had to, that the earlier and rejected draft of February 19, 1936, had an express "net proceeds derived from the sale of gas" royalty clause which was in effect replaced by the "market price" clause (note 4, supra) the Lessee-Producer's reported declarations made through its general counsel—a voice not only of management, but with an articulate awareness of the significance of legal terms—

11. American Oil Co. v. Hart, 5 Cir., 1966, 356 F.2d 657.

clearly put its construction of a market, not a proceeds, basis on this royalty clause. There were similar representations made to the FPC that under its gas leases "it is obligated to pay royalty based on the market price at the wellhead."

[4-6] We do not minimize the beguiling appeal of the Lessee-Producer's theory. Without a doubt, with the Lessors' full approval, this committed until the exhaustion of the reserves[12] all of the gas[13] to this contract and hence to this "market." But the "market" as the descriptive of the buyer or the outlet for the sale is not synonymous with its larger meaning in fixing price or value. For in that situation the law looks not to the particular transaction but the theoretical one between the supposed free seller *vis-a-vis* the contemporary free buyer dealing freely at arm's length supposedly in relation to property which neither will ever own, buy or sell.[14] It was not, as this theory would make it read, an agreement to pay ¼th of the price received from the market on which this gas is sold. Rather, it was to pay ¼th of the "market price" or "market value" as the case might be. The demand that the Lessee-Producer have a firm commitment for the sale

12. Sun Oil Co. v. FPC, 1960, 364 U.S. 170, 80 S.Ct. 1388, 4 L.Ed.2d 1639; United Gas Pipe Line Co. v. FPC, 5 Cir., 1965, 350 F.2d 689, cert. granted, 1966, 383 U.S. 924, 86 S.Ct. 930, 15 L.Ed. 2d 844.

13. The Northern contract applied to only 2,520 acres of the 6,120 acres conveyed under the R-Lease. Consequently, we think the Lessee-Producer persuasively refutes the Lessors' contention that had the intention been to confine the royalty basis to the proceeds of the Northern contract, such contract, otherwise incorporated by reference in Sec. IX, would again have been mentioned specifically.

14. As to the parties, the commodity, the market, is something less than "free" in this highly regulated gas business. See, Weymouth v. Colorado Interstate Gas Co., 5 Cir., 1966, 367 F.2d 84.

of the gas if and when produced—standing alone or in conjunction with the Northern contract—was not inconsistent with the expectation that in the great unknown—the future down to exhaustion of the reserves—the Lessors wanted payment for royalty on the current value of the gas being delivered. So too was it consistent with a desire to have any and all increases without a ceiling while prescribing always the fixed minimum as the floor. The condition precedent demand served another vital purpose. It protected the Lessors against the possibility of producing gas wells being shut in from lack of a commercial outlet, a situation presenting some vexing legal problems.[15] More important than serving attractive grist for the lawyers' mill, and fees, a shut-in is economic frustration for an indeterminate time, certainly until the Lessor can take on another formidable lawsuit to establish breach of the covenants adequately to develop and market.

[7] With this analysis falls also the claim based on estoppel. With little more we reject also the claim that the division orders of December 27, 1945, committed the Lessors for the life of the lease to this construction of the royalty clause. (See Issue No. 4, note 7, supra). Coincident with the contractual price increase effective December 27, 1945, new division orders were prepared and executed.[16] The Lessors accepted royalty settlements under

15. See Brown, The Law of Oil and Gas Leases, § 6.08, 1966 Cumulative Supplement, 87-98; especially as to Gulf Oil Corporation v. Reid, 1960, 161 Tex. 51, 337 S.W.2d 267; Skelly Oil Co. v. Harris, 1962, 163 Tex. 92, 352 S.W.2d 950, and criticizing our decision in Vernon v. Union Oil Co., 5 Cir., 1959, 270 F.2d 441, and its stare decisis offspring, Duke v. Sun Oil Co., 5 Cir., 1963, 320 F.2d 853.

16. They specifically stated on their face they are applicable to "gas run to Northern Natural" and prescribed that "the royalty and working interest [shall be] settled for on the following basis: Four cents (4¢) per thousand cubic feet * * *."

the division orders for approximately a year and thereafter attempted a unilateral revocation on January 30, 1947.

[8, 9] We think two replies of the Lessors suffice. The first is that as of the moment of execution, December 27, 1945, the royalty clause (note 4, supra) by its terms prescribed the 4¢ royalty for another six months down to June 2, 1946. More important, unless as in Union Producing Co. v. Driskell, 5 Cir., 1941, 117 F.2d 229, in which positions were significantly changed in reliance on the division order, such division orders have limited effectiveness. They do, of course, constitute a precise and definite basis for payments so that payments made in accordance with them are final and binding. Cf. Pan American Petroleum Corp. v. Long, 5 Cir., 1964, 340 F.2d 211, 222. But they may nonetheless be withdrawn as to the future. Phillips Petroleum Co. v. Williams, 5 Cir., 1947, 158 F.2d 723, 727; Chicago Corporation v. Wall, 1956, 156 Tex. 217, 293 S.W.2d 844, 847.

In thus approving the action of the trial Judge on stipulated issues 2, 3 and 4 (note 7, supra) the question left open and yet to be tried under the agreed procedural course is the "market price" of the gas run since June 2, 1946. It is the Lessors' theory that the market price during all or a part of this time has been 23¢ per MCF rather than the 4¢ or 11¢ as paid. Since this claim if sustained, nets a recovery in the neighborhood of $306,530.98[17] both as a matter of principal and principle, there is a serious question whether a Court, state or federal, either initially or ultimately, may allow any

17. Royalties actually paid aggregate $74,504.47. Royalties now claimed would approximate 95.8% of the total sales price ($319,834.96) received by Lessee-Producer from the Northern contract.

amounts fixed by jury, court, or both as increased royalty payments without express prior approval of the Federal Power Commission if, as would these, the price thus fixed would exceed levels prescribed by the FPC.

II.

FPC Primary Jurisdiction

The District Judge as to stipulated Issue No. 1 (see note 7, supra) held that the FPC had no jurisdiction over the amount to be paid royalty owners for the so-called royalty gas. This is the position taken by Lessors who vigorously oppose the contrary contention of Lessee-Producer.

In this and the other case[18] this Court was of the view that the public interest in this question loomed so large, that the Court should have at least the tentative views of the FPC. Accordingly, this Court requested that agency to file a brief amicus. Reflecting the seriousness of the problem, the Commission, after a series of extensions of time, filed a formal memorandum brief signed by its General Counsel and Solicitor. From its structure, it is apparent that it is not simply the views of its legal spokesman. It is a considered, although properly hesitant, communication by the Commission itself of its tentative views.[19] All this is demonstrated by the fact that Commissioner O'Connor filed a special statement which reflects the thorough, though ex parte, consideration given within the chambers of the Commission. Following this, the

18. Weymouth v. Colorado Interstate Gas Co., 5 Cir., 1966, 367 F.2d 84.

19. The FPC is at pains to disclaim prejudgment, recognizing quite properly that this should await a formal submission and adversary or similar proceeding.

Court expressly invited unlimited comments, replies and rejoinders from all parties in both cases.

Not unnaturally, no party seems to have been moved by these advocative arguments found in not less than 14 memorandum briefs. True, the Lessee-Producer welcomes the FPC as a somewhat strange, but nonetheless formidable, ally. But the positions remain substantially the same. The Lessors deny either jurisdiction of the FPC or the appropriateness of the exercise of any power over royalty payments and contend without reservation that this is just a typical question for court resolution on the record made at a trial. Lessee-Producer asserts that the FPC has primary jurisdiction at least to pass initially on the royalty rates which will, or might, exceed relevant FPC ceilings. The principal difference between Lessee-Producer and FPC is that the Lessee-Producer insists that this is a pure question of law to be decided by this Court whereas the FPC urges that since it is *arguable* that the matter is within its jurisdiction both the question of *jurisdiction* and, if it exists, the appropriateness of the exercise of such power, are matters for primary jurisdiction referral to the FPC for initial decision.

We find ourselves in substantial agreement with the FPC. This means that the dual questions are left open. We emphasize that here, as we do at the close, lest anyone—party, reader, the FPC, reviewing Court, or Trial or Appellate Court after reference—conclude we are declaring any conclusions other than those in Part I as to the legal effect of the gas lease and particularly the Royalty Clause (see note 4, supra) and the decision that it is appropriate that the FPC, rather than this Court, initially determine the jurisdiction of the FPC over royalty payments. Except in those two limited respects, what—and

all—we say is to set forth the respective contentions of the protagonists and illumine the problem by factors, pro and con, which might, or might not, have some relevance.

[10, 11] At the outset we recognize that this is a new application of the doctrine of primary jurisdiction. But considering the broad aim of this device and the consequent flexibility of it[20] there is really nothing startling about submitting to an agency for initial decision the question of its own jurisdiction. That this ultimately is a question of law, probably one of statutory construction, is not fatal. This Court with the express approval of the Supreme Court has ordered primary jurisdiction reference of a pure question of law—the legal validity of exculpatory tariffs.[21] More recently, we have ordered reference of far-reaching legal questions of the Transportation Act and the Agricultural Marketing Act and the interplay of each,[22] just as we have done in having an initial administrative determination of the validity of a tariff as justification for action claimed to violate the antitrust laws.[23]

[12] That that question of law happens to be one of jurisdiction does not force a different result. To the contrary, justification for judicial deferral of the jurisdictional

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20. United States v. Western Pacific R.R., 1956, 352 U.S. 59, 77 S.Ct. 161, 1 L.Ed.2d 126; Far East Conference v. United States, 1952, 342 U.S. 570, 72 S.Ct. 492, 96 L.Ed. 576.

21. River Terminals Corp. v. Southwestern Sugar & Molasses Co., 5 Cir., 1958, 253 F.2d 922, aff'd, 1959, 360 U.S. 411, 79 S.Ct. 1210, 3 L.Ed.2d 1334.

22. Agricultural Transp. Ass'n of Texas v. King, 5 Cir., 1965, 349 F.2d 873. See also, Louisville & N.R.R. v. Knox Homes Corp., 5 Cir., 1965, 343 F.2d 887.

23. Carter v. American Tel. & Tel. Co., 5 Cir., 1966, 365 F.2d 486.

question for initial resolution by an agency is even stronger than for a non-jurisdictional question. This is demonstrated by the many cases upholding the jurisdiction of administrative agencies to determine the coverage of their respective statutes and barring all attempts through judicial proceedings to avoid such determination.[24] Of even more direct pertinence to our problem are the recent cases under the National Labor Relations Act in which the Supreme Court has held that if the record indicates that a labor dispute is "arguably" subject to the jurisdiction of the NLRB, then Courts are not free to determine the question of whether the labor dispute is beyond the power of the Board.[25]

[13] We think powerful arguments can be marshalled for and against FPC jurisdiction over royalty payments. A consideration of the various factors demonstrates at

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24. The FPC memorandum brief cites as typical: Arkansas Power & Light Co. v. FPC, D.C.D.C., 1945, 60 F.Supp. 907, reversed, 1946, 81 U.S. App. D.C. 178, 156 F.2d 821, reversed, 1947, 330 U.S. 802, 67 S.Ct. 963, 91 L.Ed. 1261; United States v. Sing Tuck, 1904, 194 U.S. 161, 24 S.Ct. 621, 48 L.Ed. 917 (habeas corpus); Texas & Pac. Ry. Co. v. Abilene Cotton Oil Co., 1907, 204 U.S. 426, 27 S.Ct. 350, 51 L.Ed. 553 (common law suit for reparations); Sunshine Anthracite Coal Co. v. Adkins, 1940, 310 U.S. 381, 383, 60 S.Ct. 907, 84 L.Ed. 1263 (suit to enjoin collection of taxes, penalties, and interest demanded on the basis that, as ruled by the Coal Commission, plaintiff's coal was not exempt from the Bituminous Coal Code).

25. Marine Engineers Beneficial Ass'n, et al. v. Interlake Steamship Co., et al., 1962, 370 U.S. 173, 178, 182, 82 S.Ct. 1237, 8 L.Ed.2d 418; cf. Incres S.S. Co. v. International Maritime Workers, 1963, 372 U.S. 24, 83 S.Ct. 611, 9 L.Ed.2d 557; Myers v. Bethlehem Shipbldg. Corp., 1938, 303 U.S. 41, 58 S.Ct. 459, 82 L.Ed. 638; Boire v. Miami Herald Publishing Co., 5 Cir., 1965, 343 F.2d 17, 21; Bokat v. Tidewater Equipment Co., 5 Cir., 1966, 363 F.2d 667. See Boire v. Greyhound Corp., 1964, 376 U.S. 473, 479, 84 S.Ct. 894, 11 L.Ed.2d 849, 854, characterizing Leedom v. Kyne and McCulloch v. Sociedad Nacional, etc. (358 U.S. 184, 79 S.Ct. 180, 3 L.Ed.2d 210; 372 U.S. 10, 83 S.Ct. 671, 9 L.Ed.2d 547, as involving "extraordinary circumstances."

least two things. The first is that in the setting of its contemporary construction from the fallout of *Phillips I*[26] it is at least "arguable" that jurisdiction exists. The second is that the factors arguing against jurisdiction are of an intensely practical nature. This is especially so in terms of administrative problems from assuming jurisdiction. Consequently in divining legislative purpose, these matters should be evaluated by the agency having responsibility for operating the statutory machinery. These factors might bear directly upon the question of jurisdiction, as such, and would most certainly bear heavily upon the extent to which the FPC, either by general policy declaration, decision or rule-making, might determine the extent to which the exercise of any such power would be appropriate.

Of course the whole problem centers around whether the dealings with respect to royalty constitute a "sale in interstate commerce for resale" under § 1(b), 15 U.S.C.A. § 717(b).[27] The Act is very specific.[28] But *Phillips I* in

26. Phillips Petroleum Co. v. State of Wisconsin, 1954, 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035.

27. "The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas." 15 U.S.C.A. § 717(b).

28. "Three things and three only Congress drew within its own regulatory power, delegated by the Act to its agent, the Federal Power Commission. These were: (1) the transportation of natural gas in interstate commerce; (2) its sale in interstate commerce for resale; and (3) natural gas companies engaged in such transportation or resale."
Panhandle Eastern Pipe Line Company v. Public Service Commission, 1947, 332 U.S. 507, 516, 68 S.Ct. 190, 195, 92 L.Ed. 128, 137.

broad terms recognized FPC jurisdiction "over the rates of all wholesales of natural gas in interstate commerce, whether by a pipeline company or not and whether occurring before, during or after transmission by an interstate pipeline company." 347 U.S. 672, 682, 74 S.Ct. 794, 799.

The FPC looks upon it as another means of achieving a comprehensive effective regulatory scheme.

> "* * * When Congress enacted the Natural Gas Act, it was motivated by a desire 'to protect consumers against exploitation at the hands of natural gas companies.' Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137, 147 [80 S.Ct. 1392, 4 L.Ed.2d 1623]. To that end, Congress 'meant to create a comprehensive and effective regulatory scheme.' Panhandle Eastern Pipe Line Co. v. Public Service Commission, 332 U.S. 507, 520 [68 S.Ct. 190, 92 L.Ed. 128]. See Public Utilities Commission of Ohio v. United Fuel Gas Co., 317 U.S. 456, 467 [63 S.Ct. 369, 87 L.Ed. 396]."

FPC v. Transcontinental Gas Pipe Line Corp., 1961, 365 U.S. 1, 19-20, 81 S.Ct. 435; 445-446, 5 L.Ed.2d 377, 389. And since *Phillips*, a "natural gas" company includes an "independent producer." 18 C.F.R. 154.91.[29]

[14-17] At this point Lessors make a most formidable attack. It is the very simple, yet profound, contention that there can be no "sale" of gas by royalty owners since they have no gas to sell. And this seems to be true as a matter

29. "An 'independent producer' as that term is used in this part means any person as defined in the Natural Gas Act who is engaged in the production or gathering of natural gas and who transports natural gas in interstate commerce or sells natural gas in interstate commerce for resale, but who is not primarily engaged in the operation of an interstate pipeline."

of oil and gas law, whether based on the ownership-in-place concept followed by Texas[30] and others or on non-ownership theories of other jurisdictions.[31] For all agree that as the gas leaves the wellmouth, the entire ownership of the gas is in the lessee, none being reserved in the lessor. Thus, they urge, merely a simple debtor-creditor relationship exists between Lessee-Producer and Lessors.

30. All seem to recognize that under Texas oil and gas law, a gas lease, unlike an oil lease which undertakes to pay for or to deliver in kind royalty oil, constitutes a present sale of all of the gas in place at the time the lease is executed. Theisen v. Robison, 1928, 117 Tex. 489, 8 S.W.2d 646; Phillips Petroleum Co. v. Bynum, 5 Cir., 1946, 155 F.2d 196, 199; Phillips Petroleum Co. v. Johnson, 5 Cir., 1946, 155 F.2d 185, 190.

But although the Landowner-Lessor has no "title" in the gas in place, royalty owners possess some character of property right. See Elliff v. Texon Drilling Co., 1948, 146 Tex. 575, 210 S.W.2d 558, 4 A.L.R.2d 191 (royalty owners recover their interest in gas and distillate lost through a blowout caused by negligent operations on an adjoining lease) and see McBride v. Hutson, 1957, 157 Tex. 632, 306 S.W.2d 888. Discussing the nature of the royalty interest, the Court said that although the "royalty interest was not, in correct oil and gas legal parlance, a 'mineral interest'" it was "clearly an interest in the minerals, and in the amount of one-eighth thereof, as well as an interest subject to alienation by its owner and taxable *ad valorem* as against him as real estate." The Court went on to say: "* * * the lessor or royalty owner actually owns one-eighth of the same minerals of which the lessee owns seven-eighths, although their respective estates are of different kinds due to the fact that the royalty eighth is free of expense, while the other seven-eighths are burdened with the obligations and conditions of the lease." Young v. Rudd, 1950, Tex. Civ. App., 226 S.W.2d 469; Cates v. Greene, 1938, Tex. Civ. App., 114 S.W.2d 592; Sheffield v. Hogg, 1934, 124 Tex. 290, 77 S.W.2d 1021; Frost v. Standard Oil of Kansas, 1937, Tex. Civ. App., 107 S.W.2d 1037.

31. In 1 Williams and Meyers, Oil & Gas Law, 31, it is shown that 14 states have adopted the ownership-in-place doctrine, 8 the doctrine of nonownership, 1 a qualified doctrine, and in 9 states there is not sufficient information to provide a basis for classification. Texas, therefore, is by no means alone in recognizing and applying this concept.

[18] But this is hardly a decisive answer any more. Ever since the decision in *Rayne Field*[32] the Supreme Court has made it clear that neither the form of the transaction nor the peculiarities of state law are controlling in determining whether there is a jurisdictional sale of gas under the Act. "A regulatory statute such as the Natural Gas Act would be hamstrung if it were tied down to technical concepts of local law." 381 U.S. 392, 400, 85 S.Ct. 1517, 1522, 14 L.Ed.2d 466, 472. That case involved a sale of leasehold interests in a substantially proven and developed gas field. Such lease-sale transaction was consummated while the gas was in the ground and before a cubic foot thereof had moved in interstate commerce. Consideration for such sale of leases was measured by a lump sum price as distinguished from a price per MCF payable on production. By oil and gas business and legal tests, this was a sale of gas reserves in place. Nevertheless the Supreme Court had no difficulty in determining that it was a "sale" under the Act. "The sales of leases here involved were, in most respects, equivalent to conventional sales of natural gas which unquestionably would be subject to Commission jurisdiction under Phillips Petroleum Co. v. State of Wisconsin, 347 U.S. 672 [74 S.Ct. 794, 98 L.Ed. 1035]." 381 U.S. 392, at 401, 85 S.Ct. 1517, at 1522. The Court finding great similarity to Gray v. Powell[33] measured the transaction in practical terms. Sales of leases became sales of gas for resale because this "accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other States." Stressing its importance, the Court went on, "[t]hat is the significant and determinative economic fact

32. United Gas Improvement Co. v. Continental Oil Co., 1965, 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466.

33. 1941, 314 U.S. 402, 62 S.Ct. 326, 86 L.Ed. 301.

* * *" and "* * * because of it the Commission * * * acted properly in treating these sales of leasehold interests as sales of natural gas within the meaning of the * * * Act."[34] 381 U.S. 392, 401, 85 S.Ct. 1517, 1523. See also People of State of California v. Lo-Vaca Gathering Co., 1965, 379 U.S. 366, 85 S.Ct. 486, 13 L.Ed.2d 357.

As a corollary to the State-law-no-title-hence-no-sales-concept, the Lessors also argue that the royalty is unrelated to gas produced and is, rather, simply one part of the consideration given and received for the transfer of the gas reserves and the grant of the development privileges under the lease. Although the consideration received by the lessor frequently follows a common pattern[35] this is not necessarily so as the R-Lease in question here demonstrates. Two principal additional factors were the obligation to drill eleven wells plus the securing of an outlet through the Northern sales contract. And, with or without added unusual considerations, even royalty may

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34. Neither the Solicitor General nor the Court challenged the genuineness or the good faith of the substitute leasehold sale after conventional sales were rejected by FPC (See 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466 at 471). There is thus no indication that the result would have been different had the landowners, as lessors, made the sale of the gas reserves in place direct to Texas Eastern. And there appears to be much justification for the reading given the case in the FPC memorandum brief:

> "It can hardly be doubted * * * that the Supreme Court would have reached the same result if instead the producers in that case had fixed their compensation in terms of a royalty on all gas subsequently sold by Texas Eastern."

35. See, e.g., the description of the characteristic triad of consideration payable to the lessor:

> "The benefits accruing to a lessor under a mineral lease, come under three definite classifications, regardless of what various specific appellations may be applied to them, namely, bonus, delay rentals and royalty."

Norvell, J., Garrett v. Dils Co., 1957, 157 Tex. 92, 101, 299 S.W.2d 904, 910 (dissenting opinion).

be complex. Should it be proceeds, market value, market price, a minimum-maximum combination thereof? If a fractional interest, then what fraction — 1-8th, 3-16ths, 1-4th, 5-8ths, or what? All of these variable lead Lessors to argue that if the FPC has jurisdiction over royalties, then presumably it has jurisdiction over all other types of consideration given. Once that is established, and especially if the pattern of §§ 4 and 5 of the Act is pursued, it means that the FPC is squarely in the middle in determining, or at least approving as a § 7 condition precedent to the grant of a certificate, the terms and provisions of an initial lease between a landowner and a lessee. This would, so the argument continues, run headon into the 1(b) production or gathering proviso (see note 27, supra) and would, in any event, be concerned with transactions so remote in point of time and operation from the sale for resale as to be outside the scope of the Act.

But there are several possible answers which might ultimately be found to have merit. To hold that at some stage, the FPC has the power to review, approve or disapprove the amounts payable as royalty if in excess of FPC established ceilings, does not necessarily forecast a holding of universal jurisdiction over the making of the initial lease or the appraisal, assessment, approval or disapproval of the various elements going to make up the total consideration for the trade. There is, first, of course, the requirement that the transaction constitute a "sale for resale" or interstate transportation. This seldom occurs at this initial stage.[36]

[19] But jumping that hurdle there may be supportable reasons why royalty, for the purposes of the

36. But compare the R-Lease, executed pursuant to the condition precedent that the Northern sales contract be consummated.

Act is to be distinguished from other kinds of legal considerations. Although in legal concept it is a deferred payment for the initial grant, it bears a direct relation to current production.[37] None is due until there is production. What is due depends directly on the amount of production. As each cubic foot of gas flows through the well-mouth orifice, it is known, therefore, that some specific (or ascertainable) sum is due for that fraction of production prescribed in the royalty clause (1-8th, 3-16th, 1-4th, etc.).

And this practical consequence becomes more acute in the context of a regulated activity. Whatever may be the legal theory of title in the gas reserves, the cost of the gas to the Lessee-Producer is in two main categories. There is, first, the actual costs for exploration, development and production of all of the gas, both the working interest (e.g., 7-8ths) and the royalty (e.g., 1-8th). The second is the amount paid as royalty for the fraction prescribed as royalty. This second element is directly attributable to actual gas delivered through the well-mouth and is ordinarily measured directly thereby.[38]

The direct, immediate importance of royalty payments and the position of royalty owners in the regulatory scheme of the Act has been recognized by the FPC in both a general[39] and specific way in the area rate proceedings,[40]

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37. Occasionally it depends on nonproduction, e.g., under take-or-pay, minimum nomination requirements, etc. See Callery Properties, Inc. v. FPC, 5 Cir., 1964, 335 F.2d 1004, 1021.

38. We have treated amounts due under "take-or-pay" clauses as sales of gas. See note 37, supra.

39. On a cost of service approach, Landowner-Lessors would generally benefit from dealing with a high cost Lessee-Producer.

40. In re Phillips Petroleum Co., 1960, 24 FPC 537; Wisconsin v. FPC, 1963, 373 U.S. 294, 83 S.Ct. 1266, 10 L.Ed.2d 357 (Phillips II).

which many hope, will afford a workable solution. In the Permian Basin area rate decision, No. AR 61-1, opinion 468, 33 FPC * * * (now pending on review in the 10th Circuit), a forerunner of other area rate proceedings including the Hugoton-Anadarko area, No. AR 64-1, 30 FPC 1354, covering the gas fields involved here, it was treated as one of the significant costs.[41] Although ap-

41. Both the Examiner and the Commission calculated royalty at 12.5% (⅛th) of the selling price (presumably on a "proceeds" basis). The Commission changed the allowed amount slightly because of other adjustments. Showing that the Commission does not lump this "cost" in with others constituting both cost and consideration payable to lessor (e.g., "exploration and development costs" or "depletion, depreciation, and amortization of production investment costs") is the excerpts from Opinion No. 468:

	Cost in Cents per Mcf	
	Examiner	Commission
Exploration and Development Costs		
Dry Holes	1.07	1.42
Other Exploratory Costs	1.19	1.59
Allowance for Growth	.83	1.11
Production Operating Expense	2.88	2.70
Net Liquid Credit	(2.68)	(3.10)
Regulatory Expense	.14	.14
Depletion, Depreciation and Amortization of Production Investment Costs		
Successful Well Costs	2.16	2.42
Lease Acquisition Costs	.57	.64
Cost of Other Production Facilities	.23	.26
Return on Production Investment (at 12%)	3.91	4.38
Return on Working Capital	.20	.35
Subtotal	10.50	11.91
Royalty at 12½%	1.60	1.83
Production Taxes	.72	.90
Total	12.82	14.64

For a jurisdictional sale, royalty payments are considered an operating expense under Account Number 758, Commission's Uniform System of Accounting of Accounts for Natural Gas Companies, 18 C.F.R. Part 201, Account Number 758.

parently not discussing it in terms of cost attributable to royalty payments, the Commission recognizes generally that particular producers might be able to justify above-ceiling prices where costs exceed the area average and revenues.[42]

Its dynamic significance is dramatically illustrated by contemplating the dollar and cents impact of full success by the Lessors. Still unproved and obviously subject factually to much downward adjustment depending on proof of factors on market value,[43] the Lessors complaint demanded 23¢ MCF. This is in sharp contrast to the FPC ceiling of 11¢ MCF and far exceeds the FPC anti-trigger-

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42. "It would seem clear that where a producer who has contracted for an above-ceiling price can show that his out-of-pocket expenses in connection with the operation of a particular well are greater than the revenues under the applicable area price, he should be entitled to appropriate relief, and there may be other circumstances where a producer as a matter of law or in the public interest would be entitled to some relief." (FPC Opinion No. 468, p. 105.)

Of course this has to be read in the light of this declaration:

> "A significant early ruling in this proceeding was the Commission's order of May 14, 1962, holding that individual company cost-of-service evidence would not be received in evidence but that composite cost studies would be admissible." (FPC Op. 468, p. 2.)

and Mr. Justice Clark dissenting, Wisconsin v. FPC, 1963, 373 U.S. 294, 83 S.Ct. 1266, 10 L.Ed.2d 357, apparently forecasts constitutional questions in this event:

> "Moreover, it must be remembered that the burden of proving just and reasonable rates is on the producer and he cannot be precluded from offering relevant proof of his cost. This he will demand in the event his statistics show his costs above those fixed for his area. And so the cold truth is that, after all of its area pricing investigation and the fixing of a rate pursuant thereto, the producer aggrieved at that fate may demand and be entitled to a full hearing on his cost."

373 U.S. 328, 83 S.Ct. 1284.

43. See, Weymouth v. Colorado Interstate Gas Co., 5 Cir., 1966, 367 F.2d 84.

ing guideline of 19¢[44] This poses a substantial threat to Northern,[45] the Pipeline Purchaser, depending upon the extent to which the FPC would allow the increase in Lessee-Producer's cost of service to be passed on or, if forbidden by *Mobile*[46] contract terms the extent to which the FPC would grant § 5 relief if the lower contractual maximum (11¢) was held to be not fair and reasonable.

Even assuming FPC rejection of Lessee-Producer's requested price increases from Northern, the other possible relief to avoid confiscation—abandonment—[47] jeopardizes

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44. Commissioner O'Connor in his separate statement summarizes the FPC ceilings:

"For the pricing area here involved, the increased rate ceiling is 11.0¢ per MCF (at 14.65 psia), and the ceiling for initial rate filings is 17.0¢. See Statement of General Policy No. 61-1, 24 FPC 818. For certain filed rate schedules, subject to the producer eliminating certain escalation clauses in the underlying contract, the guidelines are 11.6¢ and 12.0¢. See Seventh Amendment to the Statement of General Policy No. 61-1, 30 FPC 1370. The antitriggering guideline has been determined to be 19.0¢. See Tenth Amendment to the Statement of General Policy No. 61-1 (Order No. 296, issued April 5, 1965). There has been no in-line determination for Texas Railroad District No. 10, and there is no just and reasonable rate yet prescribed for the area, although such a proceeding is presently in hearing. See order instituting Area Rate Proceeding (Hugoton-Anadarko Area), Docket No. AR64-1, 30 FPC 1354."

45. Northern now has 11¢ MCF field cost under the amended contract. This field cost would increase by 3¢ MCF if royalty is payable at 23¢ MCF as claimed. If passed on by Lessee-Producer to Northern, the price to Northern would increase from 11¢ to 14¢ MCF.

46. United Gas Pipe Line Co. v. Mobile Gas Service Corp., 1956, 350 U.S. 332, 76 S.Ct. 373, 100 L.Ed. 373; cf. United Gas Pipe Line Co. v. Memphis Light, Gas and Water Division, 1958, 358 U.S. 103, 79 S.Ct. 194, 3 L.Ed.2d 153.

47. Speaking of producers having excess costs, the FPC stated:

"Even in situation where producers are able to show that they are entitled to relief from the obligation to continue to sell

the interest of Northern, its immediate customers, its ultimate customers at the burner tips and the public interest generally in the withdrawal of these huge reserves from the interstate market.

The prospect affords little comfort to the Lessee-Producer here. Invoking contractual provisions which purported to release the parties in the event the subject matter came under regulation of state or federal agencies, its unilateral discontinuance of service was rejected by the Commission and the Third Circuit. J. M. Huber Corp. v. FPC, 3 Cir., 1956, 236 F.2d 550, cert. denied, 352 U.S. 971, 77 S.Ct. 363, 1 L.Ed.2d 324 (approved Continental Oil Co. v. FPC, 5 Cir., 1959, 266 F.2d 208).

To the Lessors, another telling blow against even the likelihood of FPC jurisdiction is the "historical" fact that the FPC has not yet asserted this power.[48] Indeed, the contention runs, its own administrative regulations and practices provide no machinery for passing on the level of payments of royalty made by a Lessee-Producer to a Lessor.

Amplifying its more cryptic telegraphic advices to Les-

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flowing gas at the appropriate area ceiling, in most cases it may be sufficient to permit them to abandon their unprofitable sales." FPC Permian Basin Area Rate Opinion No. 468, p. 105.

48. There are two isolated exceptions. Northern Natural Gas Producing Company, Docket Nos. G-1084 and G-1001, August 30, 1956 (unreported), 6 Oil and Gas Reporter 538 and Elk River Co. & Lumber Co., FPC Gas Rate Schedule No. 1, issued August 30, 1956 (unreported), 6 Oil and Gas Reporter 538. The FPC's memorandum brief treats these cases, and we think properly so, as "unique." Commissioner Digby, dissenting, discerned the far-reaching implications of the assertion of FPC jurisdiction "over the sale by royalty owners of gas retained either in an original commercial lease or by an overriding provision in an assignment of a lease." But as a matter of practice, the FPC has not pursued it.

see-Producer,[49] the FPC's memorandum brief is a candid statement that it has not undertaken so far to regulate royalty rates. According to the FPC's memorandum brief which we either repeat or slightly paraphrase, the FPC historically has regulated jurisdictional sales of independent producers by requiring either the operator of the producing properties or signatory working interest owners to make the certificate and rate filings required under the Natural Gas Act. It is made for all of the gas involved in the particular sales contract regardless of the number of individuals or entities who may own separate interest therein.[50] Following *Phillips I* the FPC issued its order No. 174 series[51] in which it set forth the filing requirements applicable to independent producers. Those orders provided that independent producers should

49. Apparently to respond to this Court's prehearing request for supplemental memoranda, Lessee-Producer wired the FPC:

> "We represent a lessor entitled under a gas lease to a monetary royalty based on the market price of the gas. The lessee owns eight-eighths of the gas and sells it in interstate commerce for resale. Can you advise whether the FPC fixes royalty rates between lessor and lessee or has any procedure to adjudicate such a dispute."

To this the FPC responded:

> "Reurtel November 5 Federal Power Commission does not fix royalty rates between a lessor and lessee nor does it have any procedure to adjudicate such a dispute."

50. The provisions applicable to filings by independent producers are contained in § 154.91 of the regulations, 18 C.F.R. 154.91.

51. Order No. 174, Docket No. R-138, issued July 16, 1954, 13 FPC 1195; Order No. 174-A, issued August 6, 1954, and modified September 24, 1954, 13 FPC 1255, 1410; and Order No. 174-B, issued December 17, 1954, 13 FPC 1576. These orders were the subject of extended treatment in a number of cases, but found by this Court to be nonreviewable. Magnolia Petroleum Co. v. FPC, 5 Cir., 1956, 236 F.2d 785, cert. denied, 1957, 352 U.S. 968, 77 S.Ct. 356, 1 L.Ed.2d 322; (see related cases 236 F.2d 812, 813, 816, 819, 824, 827, 828, 830, 835, 839 and editorial note 236 F.2d 785 at 793.)

file certificate applications and rate schedules, but did not undertake to distinguish between an operator and an owner of some other interest except that, in order to relieve large numbers of parties from the filing requirements, order No. 174-B, 13 FPC at 1577-1579, provided that if the operator made a filing, other interested parties were not required to file. At that time there were no provisions prohibiting a filing by a non-signatory interest owner. Nevertheless, in two decisions,[52] the FPC ruled that a non-signatory interest owner was not entitled to file under the regulations then in effect.[53] Subsequently the Commission[54] amended § 154.91 to codify the action taken by it in the *Humble* and *Midstates* cases.[55] As the regulations now stand (barring waiver for good cause)[56] only the signatory operator or signatory interest to a jurisdictional gas sales contract may file. The signatory operator is required to file under § 154.91(b). Under § 154.91(c) other signatory interest owners may file, but are not required to do so unless the operator is not a signatory party. Under § 154.91(d) a non-signatory interest owner is not permitted to file.

The upshot of it is that the FPC regulations do not presently provide for separate filings by landowner royalty in-

52. Humble Oil & Refining Co., 14 FPC 592; Midstates Oil Corp., 14 FPC 703.

53. This Court in Sun Oil Co. v. FPC, 5 Cir., 1958, 256 F.2d 233, cert. denied, 1958, 358 U.S. 872, 79 S.Ct. 111, 3 L.Ed.2d 103, affirmed the Commission's practice under § 154.91 of not permitting nonoperating, nonsignatory interest owners to file.

54. Order No. 490, 16 FPC 492.

55. Sun Oil Co. v. FPC, 5 Cir., 1958, 256 F.2d 233, cert. denied, 1958, 358 U.S. 872, 79 S.Ct. 111, 3 L.Ed.2d 103. (See note 53, supra.)

56. See § 1.7(b), 18 C.F.R. 1.7(b).

terests or overriding royalty interests who are not themselves signatory parties to the gas sales contract. Nor are operators required generally to provide information with respect to royalty interests in filing their applications for certificates to make jurisdictional sales.[57]

But Lessee-Pipeline (and the FPC memorandum brief) counter with a good deal of force that this nonaction proves little—certainly not in the light of *Phillips I* which put an end to 26 years of administrative inaction. The reach of power and the scope of regulation are not necessarily synonymous. The FPC, as any other administrative agency, has considerable discretion in determining the extent to which admitted power is to be employed, especially in terms of detailed administrative regulations.[58] And certainly this would be true if, as the FPC's memorandum brief asserts as a fact, there have been no occasions until the inquiry by this Court for the FPC either to pass upon royalty payments or its power to do so. For that matter, if the FPC finds the statutory power to exist and this is affirmed by the reviewing court, there is still a great likelihood that few of the transactions *vis-a-vis* Lessor—

57. The FPC suggests that this is the same approach it has taken with respect to percentage sales contracts (e.g., resale of the residue gas from a processing plant). Under § 154.91(e) the regulation so far has been at the processing plant end, not the sale by the Lessee-Producer to the processing plant. With admitted power to regulate the Lessee-Producer's sale to the processor, the FPC purposefully declines to do so because it is unnecessary to effective regulation. See FPC Opinion 468, Docket No. AR 61-1, p. 71.

58. See, e.g., dollar jurisdictional standards established by the National Labor Relations Board.

The FPC has done this by establishing a category of special certificate authorization for small producers. Rate and certificate filings by small independent producers, Order No. 308, October 29, 1965, 30 F.Reg. 14009.

Lessee-Producer will have to come under FPC scrutiny as such. Thus, a "proceeds" royalty transaction presents no problem. The price collected by Lessee-Producer will at all times be subject to FPC regulation, within FPC established ceilings or collected subject to refund upon determination of the fair, just and reasonable rate.[59] §§ 4, 5. Likewise, increases in the amounts payable for royalty, whether arising automatically by escalation, favored nation clauses, or the like, or through the forces of supply and demand in fixing the market price under a market price clause need not be reviewed if the increased price to be paid is still within the relevant FPC ceilings.

It might turn out, therefore, that the FPC, assuming the existence of the power to regulate the price paid for royalty for gas admittedly sold for resale and transported in interstate commerce, will be confined to two principal objectives. First, would be suitable regulations requiring the signatory working interest owner at the time of certification to report fully on the status and nature of the royalty obligations with subsequent or periodic reports as to changes thereon and the level of payments being made therefor. The second would be a requirement that before an amount in excess of the relevant FPC ceilings could be *payable*, either as a result of unilateral action by negotiation, compromise, or by court judgment, an application would first have to be filed for approval, rejection, or modification by the FPC. That hardly signals the chaos

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59. Even there, the FPC memorandum brief points out that some regulatory control might be needed, if the percentage royalty interest (e.g., 1/8th) is increased markedly (e.g., 1/4th, 3/8ths, 1/2, etc.) with consequent significant increase in the price of gas to the consumer or an impairment of the exploratory developmental activities of the producer.

to which Lessors with much feeling prophesy.[60] And chaos or not, it must be remembered that if—and so far the if is a big one—the amounts paid for royalty constitute a "rate", §§ 4, 5, then primary jurisdiction is not only a matter of initial determination by the administrative agency. Rather it then becomes the exclusive role of the agency. State of Georgia v. Pennsylvania R.R., 1945, 324 U.S. 439, 65 S.Ct. 716, 89 L.Ed. 1051; Northern Natural Gas Co. v. State Corporation Commission of Kansas, 1963, 372 U.S. 84, 83 S.Ct. 646, 9 L.Ed. 2d 601; Montana-Dakota Utilities Co. v. Northwestern Public Service Co., 1951, 341 U.S. 246, 251, 252, 71 S.Ct. 692, 95 L.Ed. 912; Socony Mobil Oil Co. v. Brooklyn Union Gas Co., 5 Cir., 1962, 299 F.2d 692, cert. denied, 371 U.S. 887, 83 S.Ct. 182, 9 L.Ed.2d 121, following the stay of this Court issued in Magnolia Petroleum Co. v. Federal Power Commission, 5 Cir., 1956, 236 F.2d 785, cert. denied, 352 U.S. 968, 77 S.Ct. 356, 1 L.Ed.2d 322.

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60. In attempting to resolve these difficult problems, the Court is not helped by the coercive tone of Lessor's statement that "if the court should yield to the FPC's demand that the parties be relegated to an administrative hearing * * * then whatever right the royalty owners in this case have is irretrievably lost. We simply cannot afford the luxury of an FPC hearing. By economic compulsion we will choose as the only feasible course of action to abandon the litigation and bow to Huber's will."

First, this is no contest between unequal combatants. On Lessors' claim for the years involved, over $300,000 is at stake with much more apt to follow on principles of collateral estoppel as to years subsequent to those in suit. Of more significance, this question is of vital importance to the public interest. Its impact will transcend the parties, the period of time involved here, and this particular relationship. In these two cases, large volumes of gas and sums of money are involved and the trial Judge observed that there are "several other similar cases on the docket of this court in the Amarillo Division."

[20] Thus we end, as we began, a consideration of these factors pro and con demonstrate that there is at least an arguable basis for FPC jurisdiction. Moreover, these factors ought first to be evaluated by the FPC in the resolution of the question of statutory power and, if that is found to exist, the necessary implementation of that in terms of the extent to which the exercise of that power is or will be appropriate. Lest we be misunderstood, we emphasize again that this analysis is merely to indicate why we conclude primary jurisdiction reference should be made, the Court all the while disclaims any purpose by what it has said or left unsaid, by its comments, express or implied, of declaring or intimating what its views are on the questions referred for initial decision by the FPC and the arguments pro and con.

III.

[21] We therefore affirm the District Court on issues Nos. 2, 3, and 4 (Note 7, supra), but vacate the holding as to issue No. 1 and remand the cause to the District Court for further consistent proceedings.[61] Specifically, the District Court should defer further action including fixing of the actual "market price" pending invocation[62] by the

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61. In view of the acute public interest, dismissal under F.R. Civ. P. 41(a) (2) is not in order but if, as suggested (note 60, supra) the Lessor declines, then the Court has ample power to require Lessee-Pipeline to go forward with the reference to FPC.

62. The FPC memorandum brief states that this may be done in a number of ways: E.g., by a complaint under § 1.6(b) or petition for declaratory order or other relief under §§ 1.7(a), (b), or (c), of the Commission's Rules of Practice and Procedure (18 C.F.R. §§ 1.6 (b); 1.7(a), (b), or (c). Other procedures in which the questions might be raised could be initiated by application for a certificate of public convenience and necessity under Part 157 or submission of a rate schedule for filing under Part 154 of the Commission's Regulations Under the Natural Gas Act (18 C.F.R. Parts 157 and 154).

parties of a ruling by the FPC: (1) (a) as to the jurisdiction of the FPC over payment for royalties for gas sold for resale and transported in interstate commerce, (b) the status of a royalty interest owner's transaction as a sale under the Act where incident to a sale for resale and transportation in interstate commerce, (c) the status of the royalty interest owner's transaction in this case as a sale under the Act; (2) if it should be determined that the FPC has jurisdiction and that at some stage or time the royalty transaction for payment therefor constitutes a sale under the Act (a) the filing requirements, if any, for certification and if required by whom and when, (b) the extent, if any, to which prior application to and approval by the FPC is required as to (i) the type, kind or nature of the royalty clause, (proceeds, market price, etc.), the percentage thereof (e.g., 1/8th, 1/4th, etc.), (ii) monetary payments which do not exceed relevant FPC ceilings, (iii) monetary payments which are or will likely be in excess of relevant FPC ceilings.

For obvious reasons we do not undertake to blueprint the proceedings before the Commission. Nor, in specifying the specific subjects of inquiry and report, do we mean to foreclose other relevant, specific inquiries or variations thereof which might be developed in the proceeding and which will or might have a significant bearing upon the substantial public issue questions of great importance. Rather, the test should be: when the FPC rules and the reviewing Court[63] enforces, will the decision likely supply

63. Under § 19 of the Act review is to the Court of Appeals. See FPC v. Texaco, Inc., 1964, 377 U.S. 33, 84 S.Ct. 1105, 12 L.Ed.2d 112. The presence of intervenors might, therefore, take review out of the 5th Circuit and return it to us later as a matter of established law.

the answers needed by the trial Court in determining precisely and to what extent matters are or are not for FPC determination and those reserved for court determination?[64]

Affirmed in part.

Reversed and remanded in part.

64. To assure that each of the respective trial Courts, the FPC and reviewing Courts will know precisely what was before us, we direct that the Clerk of this Court will on remand include in each record copies of the pre- and post-argument memoranda from Court to counsel in both cases and all briefs, memoranda filed in both cases with respect thereto. Counsel are requested to collaborate with the Clerk in affording requisite copies.